No. 87-191

Supreme Court, U.S.
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In The Supreme Court of the United States

October Term, 1987

ANN FLAMM and ARNOLD FLAMM, on behalf of a class,

Petitioners,

v.

RUDOLPH EBERSTADT, JR., and MICRODOT, INC.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MICHAEL MARTIN MULDER
(Counsel of Record)
THOMAS R. MEITES
JULIANNE C. SHIPTON
MEITES, FRACKMAN & MULDER
135 South LaSalle Street
Suite 1611
Chicago, Illinois 60603
(312) 263-0272

A. BRADLEY EBEN
230 West Monroe
Room 2220
Chicago, Illinois 60606
(312) 977-0070

Attorneys for Petitioners Ann Flamm and Arnold Flamm

Pandick Technologies, Inc., Chicago • (312) 236-0200

QUESTIONS PRESENTED

1. Did the Court of Appeals for the Seventh Circuit err when, in conflict with the Sixth Circuit in *Basic Inc. v. Levinson*, No. 86-279, *cert. granted* (Feb. 23, 1987), it adopted a *per se* rule that merger negotiations are not material under Section 10(b) of the Securities and Exchange Act and Rule 10b-5 unless and until the parties reach an agreement in principle as to price and structure?

2. Even if this Court should approve a price-and-structure rule in *Basic Inc. v. Levinson*, is full disclosure nevertheless required when the corporation goes beyond the "no comment" or "no corporate development" statement and advises shareholders how to invest in opposing a takeover?

3. Did the Court of Appeals err by holding, *sua sponte*, in conflict with this Court and other circuits, that an efficient market theory precluded petitioners from proving any damages notwithstanding prior case law that the proper measure of damages was the difference between the sale price and the price the stock would have realized on sale if the stock had not been prematurely sold?

PARTIES TO THE PROCEEDING

The caption of the case in this Court contains the names of all the parties to this proceeding.

TABLE OF CONTENTS

Page

QUESTIONS PRESENTED. i

PARTIES TO THE PROCEEDING. ii

TABLE OF AUTHORITIES. iv

OPINIONS BELOW 2

JURISDICTION 2

STATUTE AND RULES INVOLVED. 2

STATEMENT OF THE CASE 2

The Facts. 4

REASONS FOR GRANTING THE WRIT. 7

I. THE SEVENTH CIRCUIT'S PRICE AND STRUCTURE RULE CONFLICTS WITH THE SIXTH CIRCUIT'S DECISION NOW PENDING BEFORE THIS COURT IN *BASIC INC. V. LEVINSON*, NO. 86-279 7

II. ANY PRICE AND STRUCTURE RULE ADOPTED SHOULD BE LIMITED TO COMPANIES THAT DO NOT GO BEYOND "NO COMMENT" AND DO NOT COUNSEL THEIR SHAREHOLDERS ABOUT THEIR INVESTMENT DECISION TO SELL OR HOLD THEIR STOCK 10

III. THE COURT OF APPEALS' MEASURE OF DAMAGES IS IN CONFLICT WITH THAT OF THIS COURT AND OTHER CIRCUITS 12

CONCLUSION. 17

APPENDIX 1a

TABLE OF AUTHORITIES

Cases: *Page*

Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972) 13

Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976). 13, n.5

Carnation Corp., In re, Exchange Act Release No. 22,214, 33 S.E.C.Dkt. 1025 (July 8, 1985) 16, n.6

Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir. 1977) 13

First Virginia Bankshares v. Benson, 559 F.2d 1307 (5th Cir. 1977), *cert. denied*, 435 U.S. 952 (1978). . . . 10

Flamm v. Eberstadt, 814 F.2d 1169 (7th Cir. 1987). . . . . *passim*

Greenfield v. Heublein, Inc., 742 F.2d 751 (3rd Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985). 8, n.3

Janigan v. Taylor, 344 F.2d 781 (1st cir.), *cert. denied*, 382 U.S. 879 (1965) 13, n.5

Jordan v. Duff and Phelps, Inc., 815 F.2d 429 (7th Cir. 1987), *petition for cert. filed* (U.S. July 27, 1987). 9

Landreth Timber Co. v. Landreth, 471 U.S. 681 (1986) 9

Levinson v. Basic Inc., 786 F.2d 741 (6th Cir. 1986), *cert. granted*, ___ U.S. ___, 55 U.S.L.W. 3569 (Feb. 23, 1987) (No. 86-297) . . . . . *passim*

Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir. 1971). 13, n.5

Cases: *Page*

Osofsky v. Zipf, 645 F.2d 107 (2d Cir. 1981)..... 13, n.5

Panzirer v. Wolf, 663 F.2d 365 (2d Cir. 1981).... 13, n.5

Ross v. A.H. Robins Co., 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980)..... 13, n.5

SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969)....10

Staffin v. Greenberg, 672 F.2d 1196 (3rd Cir. 1982)..... 8

Strauss v. Stratojac Corp., 810 F.2d 679 (7th Cir. 1987)..... 12, n.4

Thomas v. Duralite Co., 524 F.2d 577 (3rd Cir. 1975)..... 13, n.5

Statutes, Regulations and Rules

15 U.S.C. Section 78aa 2

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. Section 78j(b)..... *passim*

28 U.S.C. Section 1254(1) 2

28 U.S.C. Section 1331 2

Rule 10b-5, 17 C.F.R. Section 240.10b-5..... *passim*

In The
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ANN FLAMM and ARNOLD FLAMM,
on behalf of a class,

Petitioners,

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RUDOLPH EBERSTADT, JR.,
and MICRODOT, INC.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Petitioners Ann Flamm and Arnold Flamm ("Flamm") and individuals similarly situated who sold their shares of Microdot, Inc. between December 5, 1975, and January 23, 1976, respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Seventh Circuit which affirmed an order of the United States District Court for the Northern District of Illinois entering judgment for the respondents following a jury trial.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Seventh Circuit, as amended, is reported at 814 F.2d 1169. The initial opinion and amendment to the opinion are reprinted in the appendix hereto, pp. 3a and 28a, *infra.*[1] The Court of Appeals' denial of the plaintiffs-appellants' petition for rehearing and suggestion for rehearing en banc is not reported. It is reprinted in the appendix, p.30a, *infra.*

JURISDICTION

The judgment of the Court of Appeals was entered on March 9, 1987. (*See* p.2a.) Rehearing and suggestion for rehearing en banc was denied by an order entered April 30, 1987. (*See* p. 30a.) This Court's jurisdiction is invoked pursuant to 28 U.S.C. Section 1254(1).

STATUTE AND RULES INVOLVED

The statute and rules involved in the proceeding are Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. Section 78j(b) (p. 31a) and Rule 10b-5, 17 C.F.R. Section 240.10b-5. (p. 32a.)

STATEMENT OF THE CASE

This class action, alleging violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, was commenced in February 1976 against Microdot and its then president, Rudolph A. Eberstadt. Jurisdiction of the district court was based on Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. Section 78aa, and 28 U.S.C. Section 1331.

Petitioners alleged that public statements, issued by Microdot in its public relations campaign against a takeover were false and misleading. In public statements Microdot advised its shareholders how to invest during the

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[1] References to "p. 1a" are to the Appendix submitted with this Petition.

six-week period between the announcement of a proposed tender at $17 per share by General Cable Corporation and the January 26, 1976 announcement of an agreement offer for the acquisition of its shares by Microdot's "white knight" Northwest Industries at $21 per share. These statements failed to disclose that, throughout that period, Microdot was searching for and negotiating with friendly bidders. Petitioners further alleged that the impact of these statements led petitioners to believe that Microdot was committed to independence to the exclusion of any merger. Thus, the misrepresentations caused them to believe that there was only a small likelihood that the market price of Microdot stock would ever exceed the then prevailing price of $17 per share while there was good probability that the stock price would decline to the pre-announcement price of $11 3/4 per share. Petitioners alleged that they were damaged when, in reliance upon those statements, they and other members of the class sold their Microdot shares during the six-week period after the announcement of the $17 offer and prior to Northwest's offer of $21 per share.

In March and April of 1986, following the District Court's certification of the class and denial of summary judgment, the case was tried to a jury which returned a verdict for both respondents and against petitioners on all counts. On March 9, 1987, the Seventh Circuit acknowledged that the jury was improperly instructed. (pp. 7a-10a.) However, it affirmed on the ground that the instructions were irrelevant, holding that respondents' pretrial motion for summary judgment should have been granted and trial avoided on the ground that the nondisclosure of the search for a white knight was immaterial as a matter of law. Rehearing was denied on April 30, 1987. (p. 30a.)

The Facts

Petitioner Arnold Flamm purchased 200 shares of respondent Microdot's stock on March 30, 1971 for $21.25 per share. (Tr. 54.)[2] He did so in his capacity as trustee for a trust set up by his father to provide income for his and petitioner Ann Flamm's grandchildren. (Tr. 54.) Microdot was a corporation that manufactured ingot molds used by the steel industry and connecting devices used for assembly work. (Tr. 54.)

On December 2, 1975 General Cable Corporation publicly announced it intended to offer $17 per share for all Microdot stock. (Tr. 55.) As a result, Microdot common stock on public exchanges jumped from $11.75 per share to $17 per share. (Tr. 62.)

Respondent Ruldolph Eberstadt, Jr., then president and chief executive officer of Microdot, immediately took steps to defend against this proposed takeover, including the retention of investment bankers Goldman, Sachs for advice concerning the fairness of the $17 offer and possible defensive strategies to defeat General's offer. (Tr. 61, 66.) Mr. Eberstadt's preference was for Microdot to defeat General and remain independent (Tr. 63), but immediate plans were made to solicit an alternative buyer, known as a "white knight," to be ready in the event that Microdot could not successfully oppose the takeover and remain independent. (Tr. 66.)

In the two weeks following General's announcement, Microdot met with five companies. (Tr. 71.) Goldman, Sachs continued the search for a merger partner for Microdot by approaching over 100 companies, including the ultimate purchaser, Northwest Industries. (Tr. 73.)

Within a few days of Goldman, Sachs' initial contact with Microdot on December 2, 1975, the possibility of Northwest Industries as a white knight was mentioned.

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[2] References to "Tr. ___" are cites to the trial transcript.

(Tr. 79.) On December 9th, Northwest communicated it was not interested. (Tr. 80.) Later in December Goldman, Sachs communicated with Northwest again and they agreed to keep an open mind until confidential new material was provided, including Microdot's cash-flow forecast for 1976-1978. (Tr. 81.) Further discussions resulted (Tr. 81), and on January 12th Northwest met with Goldman, Sachs concerning the possibility of an offer of $21 per share. (Tr. 82.) Because Northwest was not interested in waiting in the background (Tr. 83), Microdot was given a deadline of January 24th to respond. (Tr. 84.) Microdot's board recommended acceptance, and on January 27th the $21 offer was announced. (Tr. 87.) Microdot stock immediately began trading between $21 1/4 and $21 7/8 per share. (Tr. 88.) The merger was ultimately implemented in April, 1976. (Tr. 88-89.) Petitioners, who had sold between December 2nd and January 26th, filed this class action suit seeking as damages the difference between the $17 per share they received on sale and the $21 per share they would have received had they waited to sell. (Tr. 56.)

At the beginning of the period between General's intended offer and Northwest's offer, Goldman, Sachs had advised Microdot that it was important to launch a public-relations campaign aimed at assisting stockholders in making a decision on the intended offer. (Tr. 67-68.) To this end several press releases and letters were prepared by respondents in which they declared General's offer inadequate and announced a dividend increase (Tr. 70); strongly opposed this and all takeovers of mid-sized companies such as Microdot (Tr. 74); asked shareholders not to sell (Tr. 74); and announced a rise in earning. (Tr. 73). None of the announcements mentioned that Microdot was actively soliciting a "white knight." (Tr. 493.)

One such communication was a December 15, 1975 advertisement in the Wall Street Journal:

If no successful growth company of medium size

> is able to resist the raids of large outsiders, there will be no way for American stockholders to realize the potential these growth companies represent. Then there will be no future IBM, no Xerox, no Polaroid. They will be choked off and smothered as soon as they start to show their real growth potential.

(Tr. 113.) (Pltf's. Ex. 10.)

Mr. Flamm read this as being a "sort of ideological ground for opposing tender offers." (Tr. 113.) This advertisement indicated to Mr. Flamm that Mr. Eberstadt "was not interested in generating any further offers, that that was the last thing in the world he wanted. He wanted to keep this company independent at all costs." (Tr. 115.) Mr. Flamm understood Mr. Eberstadt's position to be that whether an offer was in "the form of a white knight or another hostile bid that comes in, in any case the company is no longer going to be independent and it will never have a chance to grow. . . ." (Tr. 115.)

Mr. Flamm's conclusion was reinforced by the language in a December 16, 1975 ad, also in the Wall Street Journal, titled "To American Business: Are You Next?" (Tr. 117):

> If no successful growth company of medium size is able to resist the raids of large outsiders, there will be no way for American shareholders to realize the potential that these growth companies represent. (Tr. 117.) (Pltf's. Ex. 12.)

Mr. Flamm reasoned that this result would be the same whether there was a so-called friendly white knight or a hostile raid (Tr. 119.)

In their entirety, Mr. Flamm understood these communications to mean that Microdot was committed to independence to the exclusion of any merger (Tr. 118) and would either successfully defeat General's offer and the stock would go back down to $12, or General would succeed and the stock could be sold at $17. (Tr. 121.) These public

statements indicated to Mr. Flamm that Mr. Eberstadt was not interested in generating any further offers because he wanted independence at all costs. (Tr. 115.)

If Mr. Flamm had been advised of Microdot's search for a white knight, it would have made a difference to him: he testified he might well have retained his stock to see what the outcome was. (Tr. 131.)

Given the communications he received, Mr. Flamm decided it was wisest to sell while he could still get $17 per share. (Tr. 121.) He did not see much likelihood of a higher offer in view of Mr. Eberstadt's position, and was concerned that General Cable might give up the fight, thus precipitating a sharp drop in the share price. (Tr. 121.) Thus, he sold his stock for $17 on December 29, 1975. (Tr. 78.)

REASONS FOR GRANTING THE WRIT

I. THE SEVENTH CIRCUIT'S PRICE AND STRUCTURE RULE CONFLICTS WITH THE SIXTH CIRCUIT'S DECISION NOW PENDING BEFORE THIS COURT IN *BASIC INC. V. LEVINSON, No. 86-279*

This Court has before it in *Basic Inc. v. Levinson, cert. granted*, ___ U.S. ___, 55 U.S.L.W. 3569 (Feb. 23, 1987) (No. 86-279), the question of whether merger discussions are ever material prior to the stage where companies reach an agreement in principle. The Seventh Circuit's *per se* rule in the instant case (p. 18a) that merger talks are not material until price and structure are agreed to is in direct conflict with the Sixth Circuit's decision in *Basic*, and if this Court rejects the price and structure rule in deciding *Basic*, the *Flamm* decision should be reversed.

As noted in the brief for the United States as *amicus curiae* in *Basic*, which repeatedly refers to the decision in the instant case,

In contrast to the discerning inquiry that *North-*

> *way* requires and which many courts have undertaken (see n.6, *supra*), the Third and Seventh Circuits have adopted the rule that as a matter of law merger negotiations are not material until parties reach an agreement in principle defined as an agreement on "price and structure." E.g., *Staffin*, 672 Fed.2d at 1207; *Heublein*, 742 Fed.2d at 757; see *Flamm v. Eberstadt*, No. 86-1754 (7th Cir. Mar. 9, 1987), Slip Op. 16; *Jordan v. Duff Phelps, Inc.*, No. 86-1611 (7th Cir. Mar. 17, 1987), Slip Op. 1. (Footnote omitted.)

Govt. Amicus Br. at 14, *Basic* (No. 86-279). Because the Solicitor General and respondent in *Basic* have set forth the reasons why the bright-line agreement in principle test adopted by the Seventh Circuit in the instant case and the Third Circuit in *Staffin v. Greenberg*, 672 F.2d 1196 (3rd Cir. 1982), should be rejected by this Court, those arguments will not be repeated by petitioner herein.[3]

This Court should review this case for the further important reason that the Seventh Circuit has created an

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[3] Like the brief of the United States, the brief of the petitioner in *Basic* (at 23-24, 27) finds *Flamm* in agreement with the *Staffin/Heublein* agreement in principle standard. *See Staffin v. Greenberg*, 672 F.2d 1196 (3d Cir. 1982); *Greenfield v. Heublein, Inc.*, 742 F.2d 751 (3rd Cir. 1984) *cert. denied*, 469 U.S. 1215 (1985). Both the Solicitor General (Govt. Amicus Br. at 14, n. 14) and the respondent (Resp. Br. 40-41) note that in *Flamm* the Seventh Circuit applied the agreement in principle test to what it treated as a mere failure to disclose and reserved the question of whether it would apply the same test in a case involving false or misleading corporate statements. Unlike the Solicitor General the respondent (*Id.*) seeks to distinguish *Flamm* on this basis. However, there is no principled reason why failure to disclose should be treated inconsistently from false and misleading corporate statements under the policies of Section 10(b) and Rule 10b-5 where as in this case silence would be fraudulent. (*See, infra* Argument II, pp. 10-12.) Moreover, as seen in Argument II, petitioner believes the Seventh Circuit erred in treating this case as one of silence.

inappropriate dichotomy between the disclosure obligation to shareholders in private as opposed to public corporations. Thus, in the post-*Flamm* opinion of *Jordan v. Duff and Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987), *petition for cert. filed* (U.S. July 27, 1987), the majority found that for private corporations a decision to sell and the status of price and structure negotiations in advance of agreement in principle can be material facts that require disclosure. The court stated:

> *Flamm v. Eberstadt*, 814 F.2d 1169 (7th Cir. 1987) holds that a corporation need not disclose, to investors trading in the stock market, ongoing negotiations for a merger. A public corporation may keep silent until the firms reach agreement in principle on the price and structure of the deal. See also, e.g., *Staffin v. Greenberg*, 672 F.2d 1196, 1204-07 (3rd Cir. 1982); *Reiss v. Pan American World Airways, Inc.*, 711 F.2d 11, 14 (2d Cir. 1983). Things are otherwise for closely held corporations.

815 F.2d at 431. This private/public dichotomy defeats the purpose of the securities laws by providing enhanced disclosure to those who least need it, and denying it to the very shareholders about whom Congress was mainly concerned. *See Landreth Timber Co. v. Landreth*, 471 U.S. 681, 105 S. Ct. 2297, 2306-2307, n.7 (1986).

In *Flamm* the Seventh Circuit assumed that professional investors (arbitrageurs) also enjoy enhanced disclosure, apparently because they have access to the information that Goldman, Sachs was shopping the company. Enhanced disclosure was thus enjoyed by all except the small shareholders for whom the securities laws were intended to provide particular protection. As the Solicitor General has pointed out in *Basic*, the end result of a rigid price and structure rule that merger negotiations are never material is that informed insiders could lawfully buy from the uninformed public shareholders and realize profits at their expense without ever disclosing this significant infor-

mation. (*See* Govt. Amicus Br. in Support of Pet. 13.)

This court should grant *certiorari* to resolve the conflict between the circuits and reject the price and structure rule that disadvantages the small shareholders.

II. ANY PRICE AND STRUCTURE RULE ADOPTED SHOULD BE LIMITED TO COMPANIES THAT DO NOT GO BEYOND "NO COMMENT" AND DO NOT COUNSEL THEIR SHAREHOLDERS ABOUT THEIR INVESTMENT DECISION TO SELL OR HOLD THEIR STOCK

In weighing the correctness of the bright-line agreement in principle rule rejected by the Sixth Circuit in *Basic*, this Court may desire to consider this case for the additional reason that it presents a situation where corporate statements went beyond "no comment" and "no corporate activity" to one where the corporation actively counseled its shareholders about their decision to sell or hold their stock in opposing a hostile takeover. In a situation where a company has chosen to speak by making " assertions . . . in a manner reasonably calculated to influence the investing public," *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969), a violation occurs when a public statement contains a material misrepresentation or omission of a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. In *Basic* this Court has before it the holding that, "[u]nder Rule 10b-5, '[a] duty to speak the full truth arises when a defendant undertakes to say anything' " even when the statement is "no comment." 786 F.2d 741, 747 (6th Cir. 1986). *See First Virginia Bankshares v. Benson*, 559 F.2d 1307, 1317 (5th Cir. 1977), *cert. denied*, 435 U.S. 952 (1978) and cases cited in *Basic*, 786 F.2d at 747. In the instant case the corporation's statements specifically advised the shareholders about their decision to hold or sell their stock, but withheld

information on its merger plans material to the investment decision.

When General Cable announced its hostile takeover bid, Microdot kept its merger search and discussions a secret from its shareholders. But Microdot was far from secretive on its other strategies for defeating General Cable and specifically advised its shareholders on their investment decisions, telling them not to sell their stock. Microdot also told its shareholders of its legal proceedings on antitrust grounds and opposition to General Cable in hearings before the Ohio Division of Securities. (Pltf's. Tr. Ex. 56.) It announced an increase in dividends and announced it earlier than would otherwise be customary. (Tr. 67, 69.) Microdot publicly appealed to corporate officers to bring pressure to bear on commercial banks not to handle takeovers, and it requested these corporations to lobby Congress against takeovers. (Pltf's. Tr. Ex. 12.) Moreover, Microdot advertised its personal attacks on General Cable's management, and proclaimed its preference for independence at all costs. (Tr. 74, Pltf's. Tr. Ex. 10.) Microdot investors could have reasonably viewed these announced strategies in the public press as the only ones it was employing.

Despite the evidence of Microdot's public relations campaign the Seventh Circuit found that this case did not involve false or misleading statements but indeed was only "a case of silence on the subject of the omitted information. For all practical purposes, Microdot was mum on its strategies for defeating General Cable's bid." (p. 20a.) Given Microdot's statements and investment advice, the court below's finding of silence can only refer to Microdot's silence about its white knight merger strategy. As such, the holding is unrealistically narrow. While Microdot was mum about seeking a merger, its other statements to its shareholders in response to the takeover threat resulted in a duty to disclose the whole truth about its strategies to

defeat the takeover, not just the ones it selectively chose to disclose. Even if this Court adopts an agreement in principle rule, disclosure of merger search and discussions was required in this case where the corporation advised its shareholders on their investment decisions.

III. THE COURT OF APPEALS' MEASURE OF DAMAGES IS IN CONFLICT WITH THAT OF THIS COURT AND OTHER CIRCUITS

This case also raises an important question concerning a conflict among this Court and the circuits over the proper measure of damages for violation of Section 10(b) of the Securities and Exchange Act and Rule 10b-5. At trial, petitioners contended that if they had been told that Microdot was searching for and discussing a merger with potential white knights, they would probably not have sold their stock at $17 per share, and would thereby have received the $21 per share subsequently offered by white knight Northwest Industries. The jury was then instructed, without objection from respondents, that "the measure of damages in a violation of rule 10b-5 . . . is the difference between the price at which plaintiffs sold their stock and the $21 per share Northwest Industries gave . . . to all persons who held Microdot when it made its tender offer . . . " (*See* p. 33a where the instruction as given in the district court, absent citation, is reproduced and p. 34a where respondents state they have no objection to the instruction.)[4]

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[4] As the instruction given (p. 33a) and the transcript from the instruction conference (p. 34a), reproduced in the appendix show, defendants stipulated that the proper measure of damages was the difference between the sale price and the market price subsequently achieved by the stock after the white knight offer. *See Strauss v. Stratojac Corp.*, 810 F.2d 679, 687 (7th Cir. 1987) (objection to damage instruction waived where not raised before the jury retired.) Not suprisingly then, the defendants did not

(Footnote continued on the following page)

The instruction given the jury was based on this Court's decision in *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 155 (1972), and in a number of circuits that the difference between the sale price actually received and the market price reached by the stock at a reasonable time in the future is a proper measure of damages.[5] For example, *Dupuy v. Dupuy*, 551 F.2d 1005, 1024-25 (5th Cir. 1977), held:

> Generally, a defrauded seller may recover the difference between the price for which he sold his stock and the price he would have received absent the misrepresentation or omission. *Affiliated Ute Citizens v. United States*, 1972, 406 U.S. 128, 155, 92 S.Ct. 1456, 31 L.Ed.2d 741; *Thomas v. Duralite Co.*, 3 Cir. 1975, 524 F.2d 577 . . . If the jury

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4 *(Continued)*

raise any damage issues on appeal. For an appellate court to raise such an issue which has been stipulated to below is not only contrary to law, but disrupts the principle of issue foreclosure in the appellate process. Importantly, the petitioners' fundamental right of due process to be heard was violated in that the only time they could address the issue was in the petition for rehearing after the court had its mind made up on the issue.

[5]The petitioner cited the following authority in the district court to support the instruction to the jury on damages (*see* p. 33a, where the instruction with authority as submitted to the district court is reproduced):

> *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 155 (1972); *Osofsky v. Zipf*, 645 F.2d 107, 111-14 (2d Cir. 1981) (cases collected); *Panzirer v. Wolf*, 663 F.2d 365, 368 (2d Cir. 1981); *Ross v. A.H. Robins Co.*, 607 F.2d 545, 556 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); *Dupuy v. Dupuy*, 551 F.2d 1005, 1024-25 (5th Cir. 1977); *Blackie v. Barrack*, 524 F.2d 891, 909 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976); *Thomas v. Duralite Co.*, 524 F.2d 577, 586 (3rd Cir. 1975); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir. 1971); *Janigan v. Taylor*, 344 F.2d 781, 786 (1st cir.), *cert. denied*, 382 U.S. 879 (1965).

> decides he would not have consummated the sale, it may then award the difference between the sale price and the value of the stock at a reasonable time in the future. *Myzel v. Fields*, 8 Cir. 1967, 386 F.2d 718; *Janigan v. Taylor*, 1 Cir. 1965, 344 F.2d 781, *cert. denied*, 382 U.S. 879, 86 S.Ct. 163, 15 L.Ed.2d 120.

In the instant case, the majority of the court, *sua sponte*, concluded on the basis of a so-called "efficient market theory" that petitioner failed to prove damages because "Flamm did not offer to prove that the market price was influenced by the non-disclosure at any time during the offer." (p. 20a.) The Court of Appeals' decision on an issue (which had been conceded by the appellee below and, never raised or briefed in the appellate court), is in direct conflict with the decisions of this Court and the First, Second, Third, Fifth, Ninth and Tenth circuits. (*See* footnote 5, *supra.*) Those circuits hold that damages in a Rule 10b-5 securities action are properly measured by the difference between the sale price and the market price that the stock reached within a reasonable time.

In his concurring opinion in the instant case (p. 27a), Judge Cudahy, while finding the majority result correct, expressed serious reservations about the majority's efficient market theory:

> [T]he securities laws were not written by market technicians and they put an emphasis on telling the truth and the whole truth about securities. Again I believe this is a moral dimension which may or may not contribute to wealth maximization in the context of an efficient market. It is important that we not lose sight of the moral underpinnings of the law in our concern for its economic consequences.

Indeed, under the majority's view it does not matter whether the company told the whole truth to its shareholders since most of the trading is done by professional arbitrageurs who have the information. Thus, the majority

stated (at pp. 16a-17a):

> [t]o the extent the appearance of White Knights is predicable, the *probability* of a White Knight appearing in this contest will be reflected in the price of the stock. Most buyers during tender offer contests are arbitrageurs, professional investors who are exceptionally knowledgeable. . . . When Flamm sold his stock, he passed to the arbitrageurs the risk that the price would fall. . . . Undoubtedly many arbitrageurs had learned that Goldman, Sachs was shopping for a deal. Their bids reflected the value of the potential deal, and Flamm received this value without knowing about the prospects himself. (emphasis in original)

This theory of damages, however, conflicts with the longstanding case law cited above based on the moral underpinnings of the law which holds that damages occur to the shareholders who by virtue of being misled do not achieve the price that those with the full knowledge are able to achieve.[6] What the Court below fails to take into account is the reality that in the circumstances of this case the knowledgeable arbitrageurs are ordinarily on the "buy" side of the market equation, while the uninformed small investors are invariably on the "sell" side.

The prospective sellers of Microdot stock here were members of the plaintiff class. Unlike the arbitrageurs, these sellers had no access to information about Microdot's

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[6]The Seventh Circuit indicates in *Flamm* that a corporation may have a duty to its shareholders to remain silent as to the state of merger negotiations. (pp. 13a-17a.) The court states that while some shareholders may as a result of corporate silence sell their stock at less than they might have received if they had known of the perspective merger, the silence benefits shareholders overall by an increased likelihood for a successful merger given the company's silence. *Id.* In no case should a company be allowed to remain silent where such silence would be misleading and result in a shareholder's decision being made on the basis of

(Footnote continued on the following page)

search for a white knight or about the strength of General Cable's resolve. If these sellers had actual knowledge of the ongoing search for a white knight they would have been less inclined to sell. The supply of Microdot shares offered at any given price would have declined, and the market would have reflected that decline in supply through an increase in price. This Court should therefore grant certiorari to resolve the conflict and reject the seriously flawed "efficient market" theory adopted by the Seventh Circuit in the instant case in favor of the case law relied upon above which upholds the integrity of the securities market.

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6 *(Continued)*

incorrect information. As the Securities and Exchange Commission has stated in discussing this issue in *In re Carnation Corp.*, Exchange Act Release, No. 22,214, 33 S.E.C. Dkt. 1025, 1030 (July 8, 1985):

> The importance of accurate and complete issuer disclosure to the integrity of the securities market can not be over emphasized. To the extent that investors can not rely upon accuracy and completeness of the issuer's statements, they will be less likely to invest, therefore reducing the liquidity of the securities market to the detriment of investors and issuers alike.

CONCLUSION

For the foregoing reasons, petitioners respectfully request that this Court issue a writ of certiorari to review the decision of the United States Court of Appeals for the Seventh Circuit.

MICHAEL M. MULDER
(Counsel of Record)
THOMAS R. MEITES
JULIANNE C. SHIPTON
MEITES, FRACKMAN & MULDER
135 South LaSalle Street
Suite 1611
Chicago, Illinois 60603
(312) 263-0272

A. BRADLEY EBEN
2330 West Monroe
Room 2220
Chicago, Illinois 60606
(312) 977-0070

Dated: Chicago, Illinois
July 29, 1987

APPENDIX

In The
Supreme Court of the United States
October Term, 1987

ANN FLAMM and ARNOLD FLAMM, on behalf of a class,

Petitioners,

v.

RUDOLPH EBERSTADT, JR., and MICRODOT, INC.,

Respondent.

PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

INDEX

	Page
Judgment, Court of Appeals, March 9, 1987	2a
Opinion, Court of Appeals, No. 86-1754, March 9, 1987	3a
Order Amending Opinion, Court of Appeals, March 11, 1987	28a
Order Denying Petition for Rehearing, Court of Appeals, April 30, 1987	30a
Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. Section 78j(b)	31a
Rule 10b-5, 17 C.F.R. Section 10b-5	32a
Jury Instruction 20 As Tendered By Plaintiffs	33a
Transcript Of Proceedings, April 4, 1986	34a

JUDGMENT – ORAL ARGUMENT

In The
United States Court of Appeals
For the Seventh Circuit
Chicago, Illinois 60604

ANN FLAMM and ARNOLD M. FLAMM,
Plaintiffs-Appellants,

No. 86-1754 *vs.*

RUDOLPH EBERSTADT, JR. and MICRODOT, INC.,
Defendants-Appellees.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

No. 76 C 427

Judge
Paul E. Plunkett

March 9, 1987.

Before

Hon. WILLIAM J. BAUER, Chief Judge
Hon. RICHARD D. CUDAHY, Circuit Judge
Hon. FRANK H. EASTERBROOK, Circuit Judge

This cause was heard on the record from the United States District Court for the Northern District of Illinois, Eastern Division, and was argued by counsel.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this Court that the judgment of the said District Court in this cause appealed from be, and the same is hereby, AFFIRMED, with costs, in accordance with the opinion of this Court filed this date.

In the

United States Court of Appeals

For the Seventh Circuit

No. 86-1754

ANN FLAMM and ARNOLD M. FLAMM, on behalf of a class,
Plaintiffs-Appellants,

v.

RUDOLPH EBERSTADT, JR., and MICRODOT, INC.,
Defendants-Appellees.

Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 76 C 427—**Paul E. Plunkett,** *Judge.*

ARGUED JANUARY 16, 1987—DECIDED MARCH 9, 1987

Before BAUER, *Chief Judge,* and CUDAHY and EASTERBROOK, *Circuit Judges.*

EASTERBROOK, *Circuit Judge.* The stock of Microdot, Inc., was traded on the New York Stock Exchange when General Cable Corp. announced, on December 2, 1975, an intention to make a tender offer to holders of Microdot's shares. Microdot's stock had been trading for $11¾ per share; General Cable planned to offer $17; the price available on the Exchange almost immediately topped $17, reaching $18 3/8 on December 8, 1975. The price retreated toward $17 through December, however, as Microdot opposed the offer. On December 5 Microdot issued a press release (published as an advertisement in the Wall Street

Journal on December 8) stating that the offer of $17 was unacceptable to Microdot's board of directors. It stated: "After careful consideration of the proposed offer and consulting with Goldman, Sachs & Co., our investment bankers, we have concluded that the General Cable offer is totally inadequate. We will employ all resources at our disposal to defeat the offer."

Other communications from Microdot advised the shareholders not to sell their stock, either on the market or to General Cable. Rudolph Eberstadt, Jr., the president and CEO of Microdot, bewailed the fate of medium-sized, high-tech companies in a world of takeovers, complaining that if hostile takeovers continued American industry would be less inventive. One of Microdot's ads, published in the Wall Street Journal on December 15, stated:

> If no successful growth company of medium size is able to resist the raids of large outsiders, there will be no way for American stockholders to realize the potential these growth companies represent. Then there will be no future IBM, no Xerox, no Polaroid. They will be choked off and smothered as soon as they start to show their real growth potential.

Perhaps appreciating, however, that the "growth potential" in which the investors were interested was growth from $11¾ to a higher price, Microdot also decided to see whether more than $17 could be obtained. The search for a "White Knight" was on. As it turned out, other than trying to turn up a better bid and publishing peevish advertisements, Microdot did nothing to hinder General Cable's bid. It did not have many "resources at [its] disposal to defeat the offer."

Microdot authorized Goldman, Sachs to approach other firms that might be interested. Goldman, Sachs tried its hand with more than 100 firms; not a one showed interest through December 1975. Five were persuaded to meet with Microdot's management between December 12 and 20; all five told Microdot on the spot that they were not interested in further discussions. Northwest Industries, with

which Goldman, Sachs spoke on December 12, was one of the early nay-sayers, declining to meet with Microdot's managers. Between December 20 and December 30, Goldman, Sachs could not even induce another firm to attend an exploratory meeting with Microdot's management. It is therefore no surprise that the price of the stock fell toward $17. Goldman's activity and its lack of success could not have been a secret on Wall Street; no one contacts 100 firms and escapes notice of arbitrageurs who invest millions in the stock of targets.

Goldman, Sachs kept trying, however, and after receiving more information Northwest let Microdot know that it had a lingering interest in discussing matters. Managers of the firms met on January 19. Ben W. Heineman, the president of Northwest, told Eberstadt on January 19 that Northwest was prepared to offer $21 per share in a tender offer but would not pursue the matter unless Microdot made an advance commitment to take Northwest's offer. Microdot's board made that commitment on January 24. On January 26 Northwest's board approved the offer, and the two firms made a public announcement on the same day. General Cable dropped out of the picture; Northwest acquired the stock for $21. Like many another marriage, this ended in divorce. Northwest later spun off Microdot, which is once more an independent firm traded on the New York Stock Exchange.

I

We have a suit filed by Ann and Arnold Flamm as representatives of the class of investors who sold Microdot stock between December 5, 1975, and January 23, 1976. They maintain that Microdot's search for a White Knight was material information that had been withheld, making Microdot liable under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and the SEC's Rule 10b-5, 17 C.F.R. §240.10b-5. The district court certified the class, and the case was tried to a jury. The facts we have narrated are undisputed. The parties locked horns,

however, about whether the search for the White Knight was material and whether Arnold Flamm sold his stock in reliance on a belief that Microdot was determined to remain independent. The parties and the district judge treated other members of the class as clones of Arnold Flamm, so that if he loses the whole class loses. We shall do likewise without suggesting that this is the proper approach.

Flamm, a veteran investor, sold his stock on December 29, 1975. He acknowledged at trial that he knew that White Knights frequently ride to the rescue of managers determined to resist the initial bid but unable to remain independent. He acknowledged as well that he appreciated the significance of the price of $18 3/8—professional investors were staking their own wealth behind a belief that a higher bid would come along. And although Flamm stated that he concluded after the December 15 advertisement that Microdot was determined to stay independent, he acknowledged that it was "quite possible" that he had held the stock for another two weeks on the off chance that a White Knight would gallop into view.

The district court told the jury that unless Flamm showed that the failure to disclose the search was material, and unless Flamm "justifiably relied" to his detriment on Microdot's statements and omissions, the class could not recover. The instruction stated:

> In the case of misrepresentations it must be proved that [Flamm] in fact relied upon the false statements. In other words, if you find that [Flamm] would have engaged in the transaction anyway, and that the misrepresentation or omission had no effect upon [his] decision, then there was no reliance and there can be no recovery. Further, [Flamm] must prove that [his] reliance was justified; that [he] did not intentionally close [his] eyes and refuse to investigate, concerning the circumstances in disregard of a risk known to [him], or so obvious that [he] must be taken to have been aware of it, and so great as to make it highly probable that harm would follow.

> In the case of omissions or non-disclosure of material facts, if such an omission is proved, then the element of reliance . . . may be presumed. The law infers that [Flamm] would have relied upon facts which are shown to be material and intentionally withheld. The Defendants, however, may rebut this presumption if they are able to prove, by a preponderance of the evidence, that even if the material facts had been disclosed, [Flamm's] decision as to the transaction would not have been different from what it was.

Flamm directs a barrage against this instruction. The two-tier burden was beyond the jury's ability to comprehend, he maintains, because misleading statements (half-truths) and material omissions (the rest of the truth) really are the same thing. Confusion was compounded by the phrase "misrepresentation or omission" in the first paragraph, which assigns the burden to Flamm, while the second paragraph assigns the burden on omissions to defendants. The first paragraph also states that reliance must be "justified", which means both that the investor may not "refuse to investigate" and may not act "in disregard of a risk known . . . or so obvious that [the investor] must be taken to have been aware of it". Flamm contends that both parts of this definition of "justified reliance" are wrong.

The district judge used as his model the Fifth Circuit's pattern jury instructions. These pattern jury instructions are based roughly on *Dupuy v. Dupuy*, 551 F.2d 1005 (5th Cir. 1977), a case involving a family corporation rather than trading in public markets. We disagreed with the holding of *Dupuy* in *Teamsters Local 282 Pension Trust Fund v. Angelos*, 762 F.2d 522 (7th Cir. 1985), decided almost eleven months before the trial of this case. *Angelos* reviews the extent to which "justified reliance" is an element of an action under Rule 10b-5 and holds both that investors do not have a "duty to investigate" and that "reliance" means only materiality and causation in conjunction. 762 F.2d at 527-30. See also Robert Charles

Clark, *Corporate Law* §8.10.5 (1986) ("reliance" became anachronistic in securities law when the Supreme Court made liability under Rule 10b-5 depend on scienter). Defendants concede that the instruction is erroneous under *Angelos* to the extent it mentions a "duty to investigate" but insist that the error is harmless because "investigation" did not play a role in the case. They defend the "known risk" portion of the instruction, but not persuasively.

Under *Angelos* action in the teeth of a known risk should be evaluated as part of the inquiry into materiality, not reliance. 762 F.2d at 530. If an investor knows a particular fact demonstrating a risk, the failure to disclose related or corroborating facts is not material because it does not significantly affect the mix of information on which the investor acts. Knowledge of a risk does not prevent recovery if the additional information *would* have been a significant increment to the total available knowledge.

The instruction in this case not only treats lack of knowledge of a risk as an inquiry in addition to that of materiality but also neglects to distinguish among kinds of risk. Every investor knows of risk in the abstract; there is a risk that any statement will be a lie. If this sort of knowledge were enough to defeat "justified reliance", no thoughtful investor could recover. Any reader of the business pages of the newspapers knows that White Knights appear in a significant fraction of tender offers. This is not the same as knowledge that there was apt to be a bid by a White Knight for Microdot. The critical question was whether Microdot would be among those acquired by White Knights. Material facts are those that help evaluate Microdot's chances, firm-specific information that adds to the existing knowledge that there is a probability distribution of outcomes. The instruction here allowed the jury to decide for Microdot just because Flamm knew that some firms were bailed out by White Knights—even if the failure to disclose the probability that Microdot would be among them was a material omission.

We also have some doubts about the split allocation of the risk of nonpersuasion. Perhaps this is the right one in some ethereal sense. See *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972); *Michaels v. Michaels*, 767 F.2d 1185, 1199-1200 (7th Cir. 1985). But the instruction here was garbled, and even in the best of circumstances an effort to create different burdens on functionally identical things must set jurors' heads reeling. The definition of a "misleading" statement (on which Flamm had the burden) is a half-truth, a statement true as far as it goes but deceptive because of the omission of some other truth; yet the instruction assigned the burden on omissions to defendants. It may be that a distinguishing feature of the legal mind is the ability to entertain contradictory propositions simultaneously; this is not a distinguishing feature of jurors' minds. The notion of a burden of persuasion is hard enough by itself for someone who may encounter the legal system once in a lifetime. Even Learned Hand had trouble with shadings among burdens. *United States v. Feinberg*, 140 F.2d 592, 594 (2d Cir. 1944). Several courts accordingly have held or suggested that instructions of this character not be given in jury trials. E.g., *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 188-89 (3d Cir. 1981); *Austin v. Loftsgaarden*, 675 F.2d 168, 178 n.21 (8th Cir. 1982), reversed in part on other grounds after remand under the name *Randall v. Loftsgaarden*, 106 S. Ct. 3143 (1986); *Cavalier Carpets, Inc. v. Caylor*, 746 F.2d 749, 753-57 (11th Cir. 1984); *Grossman v. Waste Management, Inc.*, 589 F. Supp. 395, 410-12 (N.D. Ill. 1984). The instruction should be avoided whenever possible in favor of a single burden—one that is not hard to come by in light of *Angelos*, which essentially removes reliance as an element independent of causation and materiality in a case under Rule 10b-5. See also *Competitive Associates, Inc. v. Laventhal, Krekstein, Horwath & Horwath*, 516 F.2d 811 (2d Cir. 1975).

Defendants assert, nevertheless, that nothing in the jury instructions materially injured Flamm. The concatenation of errors would make a harmless error inquiry very dif-

ficult. We bypass that inquiry, however, in favor of an alternative ground of affirmance. See *Massachusetts Mutual Life Insurance Co. v. Ludwig*, 426 U.S. 479 (1976). Defendants moved for summary judgment on the ground that the search for a White Knight is immaterial as a matter of law. The district court denied this motion, but we conclude that the court should have granted it. This case should not have gone to the jury, and a remand based on errors in the jury instructions would be pointless.[1]

II

An omission is material when there is a "substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder"—that is, when it "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (footnote omitted). *TSC* dealt with "materiality" under the proxy rules, but like every other court of appeals we have taken the definition in *TSC* as suitable for the term wherever it appears in securities law. E.g., *Michaels*, 767 F.2d at 1194.

Several courts of appeals have held that efforts by public corporations to arrange mergers are immaterial under this standard, as a matter of law, until the firms have agreed on the "price and structure" of the deal. *Staffin v. Greenberg*, 672 F.2d 1196, 1204-07 (3d Cir. 1982); *Reiss v. Pan American World Airways, Inc.*, 711 F.2d 11, 14 (2d Cir. 1983); *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 756-58 (3d Cir. 1984); cf. *Levinson v. Basic Inc.*, 786 F.2d

[1] The questions covered in Parts II and III of this opinion were briefed in the district court, and the subject has been aired in the opinions of several other circuits. It is accordingly unnecessary to ask for a new round of briefs from these parties.

741, 746 (6th Cir. 1986) (reserving the issue), *cert. granted*, 107 S. Ct. ____ (Feb. 23, 1987). See also *Missouri Portland Cement Co. v. H.K. Porter Co.*, 535 F.2d 388, 398 (8th Cir. 1976), and *Susquehanna Corp. v. Pan American Sulphur Co.*, 423 F.2d 1075, 1084-86 (5th Cir. 1970), which apply a similar rule to the bidder's disclosure obligations. Microdot and Northwest did not agree on the price and structure of a deal until January 24, 1976, at the earliest, the day after the period in which the last member of the class sold. On December 29, 1975, when Flamm sold, Microdot was forlornly looking for a rescuer; the most that can be said is that Microdot had authorized an investment bank to send distress signals. *Staffin* and *Reiss* treat such inquiries as immaterial.

From one perspective this conclusion is simply another cause for wonderment at the legal mind. Investors were looking at potential prices from $11.75 (if Microdot had defeated all bids) to $17 (if General Cable's bid had succeeded) to $21 (under Northwest's bid), and maybe more if a better bid were available. This is almost a 100% range. Only an addlepated investor would consider a 100% difference in price unimportant in deciding what to do. The range in this case is not unusual. Tender offers entail substantial premia compared with the prices shares carry before the bids—and afterward, should the offers be defeated. Managers who sell the firm to White Knights obtain gains in addition to those available from the initial bidders. The data may be found in Paul Asquith, *Merger Bids, Uncertainty, and Stockholder Returns*, 11 J. Financial Econ. 51, 62-72, 81 (1983); Michael Bradley, Anand Desai & E. Han Kim, *The Rationale Behind Interfirm Tender Offers: Information or Synergy?*, 11 J. Financial Econ. 183, 188-98 (1983); Frank H. Easterbrook & Gregg A. Jarrell, *Do Targets Gain From Defeating Tender Offers?*, 59 N.Y.U. L. Rev. 277, 289-91, 294-99 (1984); Gregg A. Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge?*, 28 J.L. & Econ. 151, 161-73 (1985); Wayne H. Mikkelson & Richard S. Ruback, *An Empirical Investigation of the Interfirm Equity Investment Process*, 14 J. Financial Econ. 523, 539-40 (1985).

The judges who decided *Staffin*, *Reiss*, and similar cases did not deny that the difference between merger and no merger may be substantial. They drew instead on a different strand of the Supreme Court's reasoning in *TSC*, the recognition that "[s]ome information is of such dubious significance that insistence on its disclosure may accomplish more harm than good." 426 U.S. at 448. Our colleagues on other courts of appeals have suggested two reasons why the disclosure of ongoing negotiations may "accomplish more harm than good." One is that disclosure of ongoing negotiations may befuddle the investors, leading them to think the outcome more certain than it is. E.g., *Staffin*, 672 F.2d at 1206; *Reiss*, 711 F.2d at 14 ("Such negotiations are inherently fluid and the eventual outcome is shrouded in uncertainty. Disclosure may in fact be more misleading than secrecy so far as investment decisions are concerned."); *Greenfield*, 742 F.2d at 756. The other reason is that premature disclosure may frustrate the achievement of the firm's objective, destroying the source of the value sought to be disclosed. E.g., *Staffin*, 672 F.2d at 1206-07 ("disclosure of preliminary merger negotiations would, by and large, do more harm than good to shareholders", collecting sources of support; "If the announcement is withheld until an agreement in principle . . . is reached, the greatest good for the greatest number results."); *Greenfield*, 742 F.2d at 757 ("considering the delicate nature of most merger discussions, [early disclosure] might seriously inhibit such acquisition ventures."). The cases also allude to a third rationale, the need to create a bright-line rule that will allow firms to plan corporate transactions with the assurance that they will not be condemned no matter which way they proceed on disclosure.

The first of these reasons, that disclosure may confuse investors rather than illuminate their choices, is weak. It assumes that investors are nitwits, unable to appreciate—even when told—that mergers are risky propositions up until the closing. Almost all corporate ventures, from building a new plant to angling for a merger partner, may

go well or poorly, with a probability attached to each outcome. To attribute to investors a child-like simplicity, an inability to grasp the probabilistic significance of negotiations, implies that they should not be told about new plants, new products, new managers, or any of the other changes in the life of the corporation. These new events—things with potential for boom or bust—are exactly the news on which sophisticated investors make most decisions; "old" news, with settled value, already is reflected in the price of the stock and so is no news at all. Doubtless some unsophisticated investors think that negotiations for a merger are the same thing as a completed merger, but such babes in the woods are not apt to follow contested tender offers day by day. Disclosures to the market as a whole cannot be limited to what is fit for rubes. The Wall Street Journal is filled with rumors on which investors act; Rule 175, 17 C.F.R. §230.175, allows and even encourages the disclosure of "projections" about uncertain events; any Schedule 13D filed in a tender offer will disclose a range of plans and contingent choices. These documents regularly contain statements about potential mergers, accompanied by disclaimers and cautions about risks. We do not doubt that these schedules, drafted with more haste than the prospectus used to sell newly-issued stock, are correspondingly more likely to be incomplete. But some information is almost always preferable to none. Investors, who appreciate the necessary omissions, can deal with risk. And the disclosure of a fact (such as the hiring of an investment banker to hunt up a White Knight) does not invite suit just because the search turns out poorly.

The effect of premature disclosure on the probability of merger is a much more substantial concern. Investors seek monetary returns, and few want disclosure for its own sake. To the extent investors' wealth depends on withholding information, all favor that course. So a firm that is working on a valuable invention may elect not to disclose the existence of the project, let alone daily progress. Much of the value of the invention may come from

stealing a march on rivals, a value that would be dissipated if the firm turned valuable information over to its investors and therefore inescapably to rivals. An investor who sells the day before the public disclosure of the invention cannot complain that he missed out on an increase in the price of the firm's stock, any more than the investor who sells the day before a favorable quarterly report of earnings or an increase in dividends may demand to receive the increase. See *State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843, 850 (2d Cir. 1981). The famous Texas Gulf Sulphur case furnishes another illustration. TGS found the world's biggest lode of nickel. To capitalize, it had to line up the mineral rights for the whole area. If TGS had released the assays immediately, other firms (or the owners of the surface interests) could have captured the rewards of TGS's search. TGS had to keep its find secret for a while, and investors who sold their stock while TGS was silent had no complaint. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc). TGS did its investors a favor by saying as little as possible for as long as necessary. Once TGS started disclosing it had a duty not to lie, but that's another problem (which we discuss in Part III).

Negotiations for a merger present a similar problem. Some potential acquirers may demand that negotiations proceed in secrecy. They may fear that premature disclosure may spark competition that will deprive them of part of the value of their effort, so that bids in a world of early disclosure will be lower than bids in a world of deferred disclosure. One specter facing any potential buyer is the winner's curse—the prospect that the high bidder wins the auction only because he alone has placed an unrealistically high value on the assets. Negotiations in the glare of publicity may lead putative buyers to think that whenever they locate a bargain they will be preempted by some other bidder who waits in the wings, but whenever they offer too much they will be left with their "prize". The heads-I-win-tails-you-lose quality of this process will lead either to a general reduction in offers (to

assure that no offer is too high) or to a refusal to offer the best price without being assured of victory. Either way, silence during negotiations may be beneficial for investors. See also Note, *Rule 10b-5 and the Duty to Disclose Merger Negotiations in Corporate Statements*, 96 Yale L.J. 547, 554-56 (1987). Both the New York and the American Stock Exchanges therefore suggest that listed firms postpone announcements until definitive agreements have been reached. *Staffin* quotes the manual of the American Stock Exchange. See also §202.01 of the New York Stock Exchange's manual, reproduced as an appendix to this opinion.

Flamm may reply that silence is not beneficial to *all* investors, that there is a conflict of interest between investors who sell before the disclosure and investors who hold, thereby receiving the benefits later on. See Ronald J. Gilson, *The Law and Finance of Corporate Acquisitions* 977 (1986). Perhaps so, although the corporation is not required by the securities law to favor hair-trigger sellers over other investors. From a longer perspective, however, even this conflict disappears. Investors who wanted to prescribe their managers' behavior during merger discussions would favor a rule of silence until the discussions had reached agreement on price and structure. Such discussions may occur anytime during the life of the firm. Ex ante, each investor's chance of selling during that window is small. The chance of selling for "too little" is offset by an identical chance of buying at a bargain; every sale has a buyer and a seller. Over the long run, then, the prospect of selling for too little and buying a bargain are a wash, leaving only the prospect of receiving (or scaring away) beneficial opportunities to merge. All investors would prefer whichever approach maximized their anticipated wealth.[2] The legal rule governing disclosure is like

[2] Our case is solely about the benefits and detriments of particular disclosure rules. The '34 Act is not concerned with Microdot's choice of tactics or its decision to defend, accept the first bid, or

(Footnote continued on following page)

this hypothetical bargain among investors. It applies to all firms, to all investors be they buyers or sellers, at all times. In selecting a legal rule, a court must consider the effects on all investors in all firms, not just the effects on the plaintiff.

Even the unlucky investors, such as Flamm, who sell their stock in a particular firm too soon can take comfort in knowing that they do not lose the whole gain. To the extent the appearance of White Knights is predictable, the *probability* of a White Knight appearing in this contest will be reflected in the price of the stock. Most buyers during tender offer contests are arbitrageurs, professional investors who are exceptionally knowledgable. These professionals make money by taking risk—they take the risk that all bids will vanish (and the price fall here to $11.75) in exchange for the prospect of gain from the offer (here at $17) and the chance of a higher bid. When Flamm sold his stock, he passed to the arbitrageurs the risk that the price would fall to $11.75, or even to $17 (he received $17 3/8); the arbitrageurs did not take the risk off Flamm's shoulders for free but were compensated by the possibility (remote as of December 29!) of a higher price. Undoubtedly many arbitrageurs had learned that Goldman, Sachs was shopping for a deal. Their bids reflected the value of a potential deal, and Flamm received

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[2] *continued*

seek a higher bid. See *Schreiber v. Burlington Northern, Inc.*, 105 S. Ct. 2458 (1985); *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir. 1981); cf. *Dynamics Corp. of America v. CTS Corp.*, 805 F.2d 705 (7th Cir. 1986) (analyzing defensive and auctioneering tactics wholly as questions of state law). We therefore assume that auctioneering is beneficial as a rule without entering the scholarly debate on that question. Compare Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 Stan. L. Rev. 51 (1982), with Alan Schwartz, *Search Theory and the Tender Offer Auction*, 2 J.L. Econ. & Organization 229 (1986), with Lucian Arye Bebchuk, *The Case for Facilitating Competing Tender Offers: A Last (?) Reply*, *id.* at 253, and with Alan Schwartz, *Bebchuk on Minimum Offer Periods*, *id.* at 271.

this value without knowing about the prospects himself. It is not right to reply that the arbitrageurs—"speculators", transient investors—are swiping gains that "belong" to the longer-term investors such as Flamm. Arbitrageurs must compete among themselves to buy stock. The more likely the gain from a later White Knight bid, the more any given arbitrageur is willing to pay for stock. To make a profit the arbitrageur must put his hands on the stock; to acquire the stock he must outbid other arbitrageurs, who have the same end in view; the competition ultimately passes back to Flamm and the other original investors the gains from the probability of a White Knight bid, as of December 29 (or any other date), less the premium for taking risk off Flamm's hands. Premature disclosure could have reduced the chances of an acquisition by a White Knight, and therefore reduced the bids made in the market for Flamm's stock.

So silence pending settlement of the price and structure of a deal is beneficial to most investors, most of the time. We do not think that the securities laws war against the best interests of investors. Rule 10b-5 is about *fraud*, after all, and it is not fraudulent to conduct business in a way that makes investors better off—that all investors prefer ex ante and that most prefer even ex post. Cf. *Dirks v. SEC*, 463 U.S. 646, 653-59 (1983) (liability depends on a "duty" to disclose, a duty defined in part to ensure the welfare of investors as a group).

We agree, too, with the conclusion of the other circuits that the benefits of certainty supply additional support for the price-and-structure rule. If disclosure must occur at an earlier date, how much earlier? That would be fertile ground for disputation. No matter how soon the firm announced the negotiations, investors could say that it should have done so a little sooner. The pressure to advance the date of disclosure by "just a little" (at a time) would erode the benefits of deferral. No rule other than a clear one would have staying power. The time at which information should be disclosed ought to be readily ascertainable. The price-and-structure rule will leave some questions in doubt, but it is better than any alternative.

III

Although we adopt the holding of *Staffin* and *Reiss* that public corporations need not disclose ongoing negotiations until they have produced agreement on the price and structure of the deal, that does not produce immediate victory for the defendants. There is, at least potentially, a further question whether firms may deny the existence of ongoing negotiations or shade the truth.

This question has produced a conflict among the circuits. *Greenfield* holds (over a dissent by the author of *Staffin*) that a firm may deny knowledge of new corporate developments even while in the final stages of negotiation. *Levinson* explicitly rejects this part of *Greenfield*'s holding, 786 F.2d at 748, while reserving judgment on the price-and-structure rule as applied to silent corporations. Flamm relies on *Levinson*. This is a difficult question—one on which our court in *Michaels* initially took the side of *Greenfield* but then amended the opinion to become neutral. See 767 F.2d at 1195-96.

The conclusion of *Levinson* is supported by the principle that he who speaks must tell the truth about important matters. The firm may be silent, leaving investors to take their chances, but may not lie; the lie may have greater adverse effect on the value of the stock than the premature truth. The conclusion of *Greenfield* is supported by the fact that unless the firm is entitled to conceal the negotiations, a demand by the Exchange to confirm or deny a rumor may flush out the truth no matter what the firm says, even though the firm is entitled to be silent and most investors would want it to be. Suppose a firm is engaged in negotiations that are best kept quiet, and the Exchange asks whether new developments account for activity in its stock. If the firm says yes and says why, the cat is out of the bag; if the firm says no, it faces liability for fraud; if the firm says "no comment" that is the same thing as saying "yes" because investors will deduce the truth. No corporation follows the CIA's policy of saying "no comment" to *every* inquiry; every firm reg-

ularly confirms or denies rumors, as the securities laws and the stock exchanges' rules require. The exchanges' rules require a response, not a refusal to respond, to inquiries. When a firm suddenly says "no comment", the inquisitor will realize that his suspicions have a foundation—yet the response may sow confusion all the same. If by hypothesis silence is the best course for investors, then it may be necessary to condone evasive answers, as the Third Circuit did in *Greenfield*, to put pursuers off the scent for a time. See also Gilson at 978-79; Note, 96 Yale L.J. at 558-64.

As Flamm describes the case, we must choose between *Greenfield* and *Levinson*. Microdot opposed General Cable's offer, issuing one press release after another. It told investors to hold their stock because $17 was inadequate and pledged to resist General Cable's bid by all available means. It cried wolf about the effect of tender offers on aggressive innovators. Flamm insists that he deduced from these statements that Microdot wanted to remain independent at any cost, even the return of the stock's price to $11.75. If the statements amount to a declaration of independence, then failure to disclose that Goldman, Sachs was beating the bushes for higher bids was an omission that made the statements materially misleading, just like the "no corporate developments" statements in *Greenfield* and *Levinson*.

Flamm offers an implausible reading of Microdot's statements, however. The test of materiality is objective, *TSC*, 426 U.S. at 445; *Michaels*, 767 F.2d at 1196, and no objectively reasonable reader of these comments would take them as denials of any interest in other bids, no matter how beneficial those bids were to Microdot's investors. The firm's management claimed to be representing the interests of investors, rather than to be pursuing a social philosophy that small is good no matter the cost to stockholders. None of the statements denied that the firm was searching for higher bids; the implication of the statement that General Cable's bid is "inadequate" is the contrary. *Levinson*, in contrast, dealt with five bald denials that

the firm was attempting to arrange a merger. None of the materials Microdot issued states any view on the desirability of White Knights, for the economy in general or Microdot in particular. The only concrete advice Microdot gave its investors was not to sell, because $17 was too low. As things turned out, that was wise counsel. Flamm is hardly in a position to contend that because he rejected this advice he has been deceived.

Ours is therefore a case of silence on the subject of the omitted information. For all practical purposes, Microdot was mum on its strategy for defeating General Cable's bid. Defensive strategies include seeking White Knights as well as scorched earth and other destructive maneuvers. Microdot never announced a strategy involving moats, fences, or any tactic that would rebuff all bidders; it never announced antipathy to White Knights. At the right price, any corporation is for sale—even a corporation managed by people who say that tender offers should be illegal. A target of a tender offer is not just for sale; it is For Sale. If Flamm drew a different inference, he was unreasonable, and Flamm's errors are not grounds on which to force other investors to pay damages (which is the effect of awarding damages against Microdot). We therefore affirm the judgment without choosing between *Greenfield* and *Levinson*.

IV

Lest we seem to decide by silence, we disclaim any implication that if Microdot's omissions were material, the class would have been entitled to damages. The class asked for the difference between the price ($17 to $18 3/8) that prevailed between December 5 and January 23 and the price ($21) offered by Northwest. Flamm did not offer to show that the market price was influenced by the non-disclosure at any time during the offer. If the price was uninfluenced, it must have reflected in some measure the prospect of a higher bid. Flamm's theory of damages implies that the class is entitled to keep what it got for

surrendering the opportunity of a higher bid and still receive the full price of that bid—all the while avoiding risk that the price will return to the original level.

The usual measure of damages in a case under Rule 10b-5 is the difference between what the stock fetched and what it would have been worth had all of the information been disclosed. *Affiliated Ute Citizens*, 406 U.S. at 154-55; *Alna Capital Associates v. Wagner*, 758 F.2d 562, 566 (11th Cir. 1985). (Recovery sometimes depends on the defendant's profit, but Microdot made none by deferring disclosure.) Flamm has not tried to show that the difference was other than zero, implying no recovery. See *Harris Trust and Savings Bank v. Ellis*, No. 85-2963 (7th Cir. Jan. 27, 1987), slip op. 11-13; *Mills v. Electric Auto-Lite Co.*, 552 F.2d 1239, 1247-49 (7th Cir. 1977).

To put this a little differently, this court concluded in *Mills*, 552 F.2d at 1247, that the market for the stock of widely-traded firms efficiently impounds publicly available information about that firm. See also *Metlyn Realty Corp v. Esmark, Inc.*, 763 F.2d 826, 835 (7th Cir. 1985). This implies the adoption of the "fraud on the market" approach to liability under Rule 10b-5. See *Angelos*, 762 F.2d at 529; *Levinson*, 786 F.2d at 749-51; *Peil v. Spencer*, 806 F.2d 1154, 1160-63 (3d Cir. 1986); Clark at §8.10.5; Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus. Law. 1, 9-16 (1982); Note, *The Fraud-on-the-Market Theory*, 95 Harv. L. Rev. 1143 (1982). If the plaintiff establishes that a lie, misleading statement, or omission has affected the price of the stock, he may recover without establishing that he knew of or relied on the delict; his recovery is the difference between the actual price and the price the market would have reached if traders had been fully informed. The fraud-on-the-market theory is an important ingredient of class actions in securities cases, too, for otherwise individual differences in knowledge and reliance would make the class unmanageable. See *Levinson*, 786 F.2d at 750; Hal S. Scott, *The Impact of Class Actions on Rule 10b-5*, 38 U. Chi. L. Rev. 337, 345-56 (1971).

The fraud-on-the-market approach relieves the plaintiff of the need to show that he relied on or even read the misleading or incomplete disclosures; he receives a measure of damages based on the premise that actual versus "right" price is the appropriate comparison. The logic of this approach, however, implies that for widely traded securities *only* fraud on the market will establish entitlement to relief. Fraud-on-the-plaintiff won't do—not when the market price itself was unaffected and therefore "right". Flamm did not try to show that the price he received had been diminished by the omission of which he complains. If we take the fraud-on-the-market approach to its logical limit, that is dispositive against him. The competing position is that fraud on the market is just one way among many to show reliance and damages; a plaintiff who demonstrates particular reliance still may recover. Both the cases and respected scholars have vacillated between these perspectives. We need not and do not decide today whether *only* fraud on the market allows recovery in a case of this sort, and we hope that the issue will not be passed by in silence by future litigants.

AFFIRMED

Appendix

202.00 Material Information

202.01 Internal Handling of Confidential Corporate Matters

Unusual market activity or a substantial price change has on occasion occurred in a company's securities shortly before the announcement of an important corporate action or development. Such incidents are extremely embarrassing and damaging to both the company and the Exchange since the public may quickly conclude that someone acted on the basis of inside information.

Negotiations leading to mergers and acquisitions, stock splits, the making of arrangements preparatory to an exchange or tender offer, changes in dividend rates or earnings, calls for redemption, and new contracts, products, or discoveries are the type of developments where the risk of untimely and inadvertent disclosure of corporate plans are most likely to occur. Frequently, these matters require extensive discussion and study by corporate officials before final decisions can be made. Accordingly, extreme care must be used in order to keep the information on a confidential basis.

Where it is possible to confine formal or informal discussions to a small group of the top management of the company or companies involved, and their individual confidential advisors where adequate security can be maintained, premature public announcement may properly be avoided. In this regard, the market action of a company's securities should be closely watched at a time when consideration is being given to important corporate matters. If unusual market activity should arise, the company should be prepared to make an immediate public announcement of the matter.

At some point it usually becomes necessary to involve other persons to conduct preliminary studies or assist in other preparations for contemplated transactions, e.g., business appraisals, tentative financing arrangements, attitude of large outside holders, availability of major blocks

of stock, engineering studies and market analyses and surveys. Experience has shown that maintaining security at this point is virtually impossible. *Accordingly, fairness requires that the company make an immediate public announcement as soon as disclosures relating to such important matters are made to outsiders.*

The extent of the disclosures will depend upon the stage of discussions, studies, or negotiations. So far as possible, public statements should be definite as to price, ratio, timing and/or any other pertinent information necessary to permit a reasonable evaluation of the matter. As a minimum, they should include those disclosures made to outsiders. Where an initial announcement cannot be specific or complete, it will need to be supplemented from time to time as more definitive or different terms are discussed or determined.

Corporate employees, as well as directors and officers, should be regularly reminded as a matter of policy that they must not disclose confidential information they may receive in the course of their duties and must not attempt to take advantage of such information themselves.

In view of the importance of this matter and the potential difficulties involved, the Exchange suggests that a periodic review be made by each company of the matter in which confidential information is being handled within its own organization. A reminder notice of the company's policy to those in sensitive areas might also be helpful.

A sound corporate disclosure policy is essential to the maintenance of a fair and orderly securities market. It should minimize the occasions where the Exchange finds it necessary to temporarily halt trading in a security due to information leaks or rumors in connection with significant corporate transactions.

While the procedures are directed primarily at situations involving two or more companies, they are equally applicable to major corporate developments involving a single company.

CUDAHY, *Circuit Judge*, concurring in the judgment and concurring in part:

I admire the majority opinion which I think cogently and clearly leads us through the cases and the economic theory required to come to grips with the problem before us. I have, however, important reservations or differences in perspective which require me to write separately—but not at great length.

First, I think the case could be decided, reaching the same result as the majority, on the issues of the instructions and the admission of evidence as the parties presented them. There were errors in the instructions but, taken in context, I am reasonably confident they were harmless. The instructions erred primarily in foisting some sort of erroneous burden of investigation on the plaintiffs. But the evidence does not present any real issue of investigation, and this error seems harmless. The majority does not mention the alleged errors of admission and exclusion of evidence, but here I would also find no reversible error.

Second, I am willing, though not eager, to go beyond the issues as presented by the parties to agree that the defendants win as a matter of law. The majority feels that this approach requires the adoption of a bright-line test (agreement on price and structure) and the specific approval of *Staffin v. Greenberg*, 672 F.2d 1196 (3d Cir. 1982) and *Reiss v. Pan American World Airways, Inc.*, 711 F.2d 11 (2d Cir. 1983).[1] I understand the majority's preference for a bright-line rule. If the secrecy of merger negotiations is in most investors' ultimate best interest (a plausible premise though not necessarily one carved in stone), there is certainly an argument for keeping them quiet until agreement in principle is reached. (And, of course, here

[1] Unlike the majority, I cannot conclude that the second circuit has adopted the price-and-structure rule. Nowhere does *Reiss* adopt a price-and-structure or any other bright-line test. *See Reiss*, 711 F.2d at 13-14.

we are apparently considering only the welfare of investors.) My problems with the majority's conclusion are primarily procedural—not necessarily substantive. We have heard no argument on the important issues which the majority boldly decides based on its own—no doubt well-informed—notions of how the corporate world turns. The Securities and Exchange Commission might have given us *its* views had it not thought this a case about instructions and evidence.[2] I do not think it is necessary—or wise—to be so bold. I would merely hold that on the specific facts of this case there has been no nondisclosure or misrepresentation from which a reasonable jury could conclude that the securities laws had been violated. The evidence, as the majority has reviewed it, supports this conclusion, and that is all we are required to decide. To go on to lay down general rules applicable to all failure-to-disclose cases—even when the rules have been the subject of considerable litigation and academic debate—is simply not called for.

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[2] In its brief for the United States as amicus curiae filed in support of the petition for *certiorari* in *Levinson v. Basic, Inc.*, 786 F.2d 741 (6th Cir. 1986), *cert. granted*, 55 U.S.L.W. 3569 (U.S. Feb. 23, 1987) (No. 86-279) the Solicitor General urged the Supreme Court to reject the price-and-structure rule adopted by the Third Circuit in *Staffin v. Greenberg*, 672 F.2d 1196 (3d Cir. 1982), and *Greenfield v. Heublein, Inc.*, 742 F.2d 751 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985). The Solicitor General stated:

> The Third Circuit's test . . . could be read to permit corporations freely to issue intentionally false or misleading statements denying merger talks that any reasonable investor would consider important to his investment decision, misleading investors into making investment decisions on the basis of incorrect information. . . . Moreover, if merger negotiations are deemed immaterial until an agreement in principle is reached, the corporation, or its insiders who are privy to the negotiations, could acquire the corporation's securities, taking advantage of uninformed shareholders by trading without making any disclosure of the negotiations.

Brief for the United States at 11-13, *Levinson* (86-279).

The Securities and Exchange Commission's opposition to the price-and-structure rule should be a matter of serious concern to this court.

Third, I believe at several points in the majority opinion the moral underpinnings of the law are at risk in the sweep of the economic analysis. For example, in its generally approving discussion of *Greenfield v. Heublein, Inc.*, 742 F.2d 751 (3d Cir. 1984), the majority speaks kindly of lying in the interest of maintaining the secrecy of merger negotiations. Such an analysis may be economically rational and may tend to maximize investors' wealth but it does seem to raise a few old-fashioned questions of corporate morality. Without pursuing the matter here, I do not think it is the place of the courts to undermine business morality even in the name of shareholder wealth maximization.

Fourth, I think the majority opinion is interesting and generally correct in most of its observations about fraud-on-the-market theory. Although their activities are not directly relevant, chartists and tape-readers find all they need to know about securities in their price (and sometimes in their volume of trading). True "technicians" eschew balance sheets, news, rumors and information of any kind outside the price as a distraction from the real, true and complete information discounted in the price attained in an efficient market. Perhaps, this is the right approach to security analysis (although I am certainly not suggesting that this is what the majority has in mind). But the securities laws were not written by market technicians and they put an emphasis on telling the truth and the whole truth about securities. Again I believe this is a moral dimension which may or may not contribute to wealth maximization in the context of an efficient market. It is important that we not lose sight of the moral underpinnings of the law in our concern for its economic consequences.

A true Copy:

Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

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No. 86-1754

In The
United States Court of Appeals
For the Seventh Circuit
Chicago, Illinois 60604

ANN FLAMM and ARNOLD M. FLAMM, on behalf of a class,
Plaintiffs-Appellants,
v.
RUDOLPH EBERSTADT, JR., and MICRODOT, INC.,
Defendants-Appellees.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

No. 76 C 427

Judge Paul E. Plunkett

March 11, 1987

Before

Hon. WILLIAM J. BAUER, Chief Judge
Hon. RICHARD D. CUDAHY, Circuit Judge
Hon. FRANK H. EASTERBROOK, Circuit Judge

ORDER AMENDING OPINION

The Court, *sua sponte,* amends its opinion in the above-entitled case issued March 9, 1987, as follows:

The second paragraph of footnote 2 of the concurring opinion should read as follows:

"The majority, of course, adopts the Third Circuit's standard in the context of nondisclosures, as enunciated in *Staffin,* but finds that on the present facts it need not

decide whether to follow *Greenfield* and adopt the same standard in the context of misrepresentations. The Securities and Exchange Commission's opposition to the price-and-structure rule apparently in both contexts should be a matter of serious concern to this court."

SO ORDERED.

In The
United States Court of Appeals
For the Seventh Circuit
Chicago, Illinois 60604

ANN FLAMM and ARNOLD M. FLAMM, on behalf of a class,
Plaintiffs-Appellants,
v.
RUDOLPH EBERSTADT, JR., and MICRODOT, INC.,
Defendants-Appellees.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

No. 76 C 427

Judge
Paul E. Plunkett

April 30, 1987

Before

Hon. WILLIAM J. BAUER, Chief Judge
Hon. RICHARD D. CUDAHY, Circuit Judge
Hon. FRANK H. EASTERBROOK, Circuit Judge

ORDER

Plaintiffs-appellants filed a petition for rehearing and suggestion of rehearing en banc on April 6, 1987. No judge in regular active service has requested a vote on the suggestion of rehearing en banc, and all of the judges on the panel have voted to deny rehearing. The petition for rehearing is therefore DENIED.

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange–

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(June 6, 1934, ch. 404, title I, § 10, 48 Stat. 891.)

§ 240.10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

(Sec. 10; 48 Stat. 891; 15 U.S.C. 78j)

[13 Fr 8183, Dec. 22, 1948, as amended at 16 FR 7928, Aug. 11, 1951]

If you find that either or both of the defendants are liable with respect to any of plaintiffs' three claims, then you must decide the amount of damages to award the plaintiffs. In a case such as this one the measure of damages for a violation of Rule 10b-5, fiduciary duty, or negligent misrepresentation is the difference between the price at which the plaintiffs sold their stock and $21 per share Northwest Industries gave to the shares and which price it offered to all persons who held Microdot shares when it made its tender offer on January 26th.

Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 155 (1972); *Osofsky v. Zipp*, 645 F.2d 107, 111-14 (2d Cir. 1981) (cases collected); *Panzirer v. Wolf*, 663 F.2d 365, 368 (2nd Cir. 1981); *Ross v. A.H. Robins Co.*, 607 F.2d 545, 556 (2nd Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); *Dupuy v. Dupuy*, 551 F.2d 1005, 1024-25 (5th Cir. 1977); *Blackie v. Barrack*, 524 F.2d 891, 909 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976); *Thomas v. Duralite Co.*, 524 F.2d 577, 586 (3rd Cir. 1975); *Mitchell v. Texas Gulf Sulphur Co.*, 446 (1971); *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

Flamm Plaintiffs' Instruction *No. 20*

Transcript Excert (Tr. 585)

some part in bringing about the injury or damage," and we are putting in your language, "If it contributed in some way to bringing about."

Is your paragraph then the same?

MR. LAIDLAW: I believe so.

MR. MEITES: Yes. We can work this out. All right. There are only two instructions left.

MR. LAIDLAW: Yes. 19, no objection; 20, no objection; 21, no objection. What else? . . . .

No. 87-191

Supreme Court, U.S.
FILED
AUG 28 1987
JOSEPH F. SPANIOL, JR.
CLERK

In The

Supreme Court of the United States

October Term, 1987

ANN FLAMM and ARNOLD FLAMM,
on behalf of a class,

Petitioners,

v.

RUDOLPH EBERSTADT, JR.,
and MICRODOT, INC.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

GERALD D. SKONING*
ANDREW R. LAIDLAW
EDWARD J. KARLIN
SEYFARTH, SHAW, FAIRWEATHER
& GERALDSON
Suite 4200
55 East Monroe Street
Chicago, Illinois 60603
(312) 346-8000

Attorneys for Respondents

**Counsel of Record*

Pandick Technologies, Inc., Chicago • (312) 236-0200

QUESTIONS RESTATED

1. Whether the Seventh Circuit properly affirmed the district court's judgment in ruling that, since investors were aware of Microdot's search for a "white knight," Microdot's disclosures neither omitted nor misrepresented any material fact?

2. Whether the Seventh Circuit described the proper standard for measuring damages in this case?

STATEMENT REQUIRED BY RULE 28.1

Respondent, Microdot, Inc., is currently a corporation which has no parent company, nor any affiliates or subsidiaries which are not wholly-owned by Microdot.

TABLE OF CONTENTS

Page

QUESTIONS RESTATED.. i

STATEMENT REQUIRED BY RULE 28.1. ii

TABLE OF CONTENTS iii

TABLE OF AUTHORITIES. iv

STATEMENT OF THE CASE 2

REASONS FOR DENYING THE WRIT. 8

I. THE SEVENTH CIRCUIT'S DECISION CORRECTLY AFFIRMED THE DISTRICT COURT'S JUDGMENT UNDER WELL-SETTLED LAW AND THE FACTS OF THIS CASE, AND THE DECISION IS NOT IN CONFLICT WITH ANY OTHER COURT OF APPEALS DECISION 8

A. Regardless Of The Manner In Which This Court Decides *Basic, Inc. v. Levinson*, The Decision Of The Court Of Appeals In This Case Is Correct. 8

B. A Public Corporation Which Has Given Good Investment Counsel To Its Stockholders Should Not Be Held Liable For Damages Under The Securities Exchange Act. 9

II. THE COURT OF APPEALS DESCRIBED THE PROPER STANDARD FOR MEASURING PLAINTIFFS' DAMAGES 10

CONCLUSION. 13

TABLE OF AUTHORITIES

Page

Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 92 S.Ct. 1456 (1972) 11

Beissinger v. Rockwood Computer Corporation, 529 F. Supp. 770 (E.D. Pa. 1981) 12

Flamm v. Eberstadt, 814 F.2d 1169 (7th Cir. 1987) 2, 3, 9, 10, 11

Greenfield v. Hueblein, Inc., 742 F.2d 751 (3d Cir. 1984), *cert. denied* , 469 U.S. 1215, 105 S. Ct. 1189 (1985) 2

In Re Warner Communications Securities Litigation, 618 F. Supp. 735 (S.D.N.Y. 1985), *aff'd*, 798 F.2d 35 (2d Cir. 1986). 12

J. G. Rubinstein v. IU International Corporation, 506 F. Supp. 311 (E.D. Pa. 1980) 12

Levinson v. Basic, Inc., 786 F.2d 741 (6th Cir. 1986), *cert. granted*, ___ U.S.___, 107 S.Ct. 1284 (1987). 2, 8, 9

Lucas v. Florida Power & Light Co., 765 F.2d 1039 (11th Cir. 1985) 10

Securities and Exchange Commissions v. Coffey, 493 F.2d 1304 (6th Cir. 1974), *cert. denied* , 420 U.S. 908, 95 S.Ct. 826 (1975). 8

Seibert v. Sperry Rand Corporation, 586 F.2d 949 (2d Cir. 1978) 8

Warner Communications, Inc. v. Murdoch, 581 F. Supp. 1482 (D. Del. 1984) 9

No. 87-191

In The
Supreme Court of the United States
October Term, 1987

ANN FLAMM and ARNOLD FLAMM,
on behalf of a class,

Petitioners,

v.

RUDOLPH EBERSTADT, JR.,
and MICRODOT, INC.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

Respondents Rudolph Eberstadt, Jr. ("Eberstadt") and Microdot, Inc. ("Microdot") respectfully request that the Petition For A Writ Of Certiorari To The United States Court of Appeals For The Seventh Circuit ("Petition") filed by Ann Flamm and Arnold Flamm (collectively "Flamm") be denied. Contrary to contentions contained in the Petition, the decision of the Court of Appeals for the Seventh

Circuit in this case does not conflict with the decision of the Sixth Circuit in *Levinson v. Basic, Inc.* 786 F. 2d 741 (6th Cir. 1986), *cert. granted,* ___ U.S. ___, 107 S.Ct. 1284 (1987).[1] To the contrary, the decision in this case does not rest upon the legal duty to disclose merger negotiations, but rather, upon unique factual issues. Both the jury and the Court of Appeals concluded that the disclosures made by Microdot to the investing public fully and truthfully disclosed all material information. Furthermore the Seventh Circuit applied well-established legal theories in describing the burden which Petitioners must sustain to prove their damages. The opinion neither modified nor departed from settled principles of law. In light of the foregoing, the Petition fails to present this Court with any issue which is appropriate for review.

STATEMENT OF THE CASE

Petitioners' Statement Of The Case is replete with inaccuracies and omissions. However, rather than burdening this Court with a point-by-point rejoinder, Respondents submit that the Seventh Circuit's recitation of the facts is fully accurate and complete. Morever, only three proven facts need be highlighted in order

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[1] The Petitioners' claim that the Seventh Circuit adopted a *per se* rule that merger talks are not material until agreement has been reached upon price and structure. (Petition at p. 7). This *per se* rule allegedly comports with the Third Circuit's decision in *Greenfield v. Hueblein, Inc.*, 742 F. 2d 751 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215, 105 S.Ct. 1189 (1985), and conflicts with the Sixth Circuit's opinion in *Levinson v. Basic, Inc.*, 786 F. 2d 741 (6th Cir. 1986), *cert. granted,* ___ U.S. ___, 107 S.Ct. 1284 (1987). Yet, the Petition fails to acknowledge the Seventh Circuit's language which specifically declines to choose between *Greenfield* and *Levinson*: "We therefore affirm the judgment without choosing between *Greenfield* and *Levinson.*" (814 F. 2d at 1179). In fact, the Seventh Circuit's opinion in this case does not conflict with *Levinson*. Rather, it rests upon unique facts which demonstrate that full disclosure did occur.

to demonstrate (as demonstrated to the satisfaction of the jury and the Court of Appeals), that Flamm in particular and Microdot investors in general knew and understood that Microdot would seek a white knight bid in response to a hostile takeover attempt by General Cable Corporation.[2] These facts are of conclusive significance since the gravamen of Flamm's complaint was that Microdot investors were defrauded by a series of press releases and advertisements which either: (a) failed to disclose that Microdot was soliciting white knight bids; or (b) misled Microdot stockholders into believing that Microdot would never accept a white knight bid. As discerned by both the jury (after a trial on the merits) and the Seventh Circuit, neither allegation has merit since Flamm in particular and the market in general knew and understood that a white knight bid could be solicited or received by Microdot. Microdot stockholders were neither misled nor deceived by the Defendants.

---

[2] In addition to the three facts highlighted herein, Respondents also must correct a misimpression created by the Petition. Flamm asserts that the jury instructions delivered in this case were found to be reversible error (Petition at p. 3). In fact, while the majority opinion indicated that the jury instructions were in some respects erroneous, it declined to decide whether those errors were harmless (814 F. 2d at 1174). The concurring opinion, however, did conclude that any errors contained in the instructions were harmless (814 F. 2d at 1181). In the event that the Petition is granted, disposition of this case will require an examination of not only the legal and factual questions raised in the Petition and Response, but also the jury instructions delivered by the district court. The jury found for the Respondents on all counts of the Complaint. Therefore, the judgment of the district court must be affirmed unless this Court were to find that the jury instructions constituted reversible error.

A. Microdot's December 5, 1975 Disclosure Put Flamm On Notice That A White Knight Bid Might Be Solicited.

On December 5, 1975, Microdot mailed to its stockholders the first of several communications regarding General Cable's proposed hostile takeover of Microdot (Tr. 442). This communication enclosed both a letter from Eberstadt to the stockholders and the text of a December 5, 1975 press release issued by Microdot (See p. 1a where Plaintiffs' Exhibit 6, the December 5, 1975 letter and attached press release, is reproduced). In part, the press release advised Microdot stockholders that:

> After careful consideration of the proposed offer and consulting with Goldman, Sachs & Co., our investment bankers, we have concluded that the General Cable offer is totally inadequate. *We will employ all resources at our disposal to defeat the offer.*"

(Pl. Ex. 6, emphasis added).

At trial, Flamm admitted that: (a) he saw the letter and press release (Tr. 103), and (b) the information contained in the letter and press release alerted him to the fact that one resource available to Microdot to defeat the General Cable offer was the solicitation of white knight bids:

Q. All right. Now, also in Plaintiffs' Exhibit 6, do you see the last sentence in the news release, the second paragraph there, where it says, "We will employ all resources at our disposal to defeat the offer"?

A. I do see that, yes.

Q. When you read that in '75, what did that mean to you?

A. Well, I don't remember my exact reaction, but I assume it meant just, you know, what it said, that they were going to employ all resources to defeat the offer.

Q. And when you read that, you understood that one of

those means would be to try and find a higher offer, didn't you?

A. Well, it was certainly, one of the possible means that was available, yes.

* * *

Q. You also knew that one of the resources at their disposal to defeat that offer was to find a higher offer, a white knight, right?

A. Yes.

(Tr. 146-147).

Thus, Microdot's very first disclosure to stockholders alerted Flamm to the possibility of Microdot's soliciting a white knight bid. His claim that Microdot failed to disclose the search for a white knight is simply unsupportable on this record.

B. Flamm's Subsequent Conduct Confirmed His Awareness Of Microdot's Solicitation Of White Knight Bids.

While generally aware that a white knight bid could be solicited, Flamm claimed that certain Microdot advertisements published on December 15 and 16, 1975, convinced him, and others like him, that Microdot would never accept a white knight bid (Petition at p. 6). Flamm read the statements contained in those advertisements as a "sort of ideological ground for opposing tender offers." (Tr. 113). Although Flamm claims that he "understood these communications to mean that Microdot was committed to independence to the exclusion of any merger" (Petition at p. 6), his subsequent conduct belies his claim.

Flamm testified at trial that the December 16, 1975 advertisement reinforced his decision to sell his Microdot shares (Tr. 118). Despite the fact that on December 16, 1975, Flamm was convinced that he would sell his Microdot shares, he delayed the sale of those shares until December 29, 1975, a period of nearly two weeks! Flamm admitted that he delayed the sale of his Microdot shares for this two-

week period in order to see whether a white knight bid developed:

> Q. Isn't it in fact true, Mr. Flamm, you waited another two weeks to sell because you were waiting to see if there was a higher offer?
>
> A. I don't recall that being the case. It certainly – you know, I don't recall why I waited, but it is certainly possible that that was one of the factors that caused me to hold off, to see if something else came through, yes, it is quite possible.

(Tr. 191).

If Microdot's disclosures had really convinced Flamm that Microdot would never accept a white knight bid, why did Flamm delay the sale of his Microdot shares for a period of two weeks in order to see whether a white knight bid developed? The answer is simple. Microdot's disclosures never misled Flamm in any respect. Rather, Flamm independently made a bad investment decision. His bad investment decision, however, was not caused by fraud or deception on the part of Microdot as the jury properly concluded.

C. The Price Movement Of Microdot Shares Demonstrated That Market Investors As A Whole Recognized That A White Knight Bid Might Be Forthcoming.

In addition to evidence regarding Flamm's personal knowledge of a possible white knight bid, Respondents' evidence at trial demonstrated that market investors as a whole knew and understood that a white knight bid could be made. Respondents presented the prices for trades in Microdot stock between December 1, 1975 and January 16, 1976. On repeated occasions during that period, Microdot stock traded in excess of the maximum price proposed by General Cable (Defendants' Ex. 40). Indeed, Flamm himself admitted that investors would only purchase Microdot stock at a price in excess of General Cable's proposed maximum price if they believed that a higher-priced, white

knight bid was forthcoming:

Q. Now, the Microdot stock went up higher than that, didn't it?

A. I believe at one point it went up to – was it $ 18, or something of that sort, for a day or so.

Q. Wasn't it in fact over 18, 18 and something?

A. It could be I don't remember.

Q. Now, at least the market believed that there would be a higher offer, didn't they?

A. Well, at least one guy who was buying the stock believed it, yes.

Q. Well, isn't that true, in a tender offer situation the stock price doesn't go above the offer price unless somebody thinks there is going to be a higher offer?

A. I think that is probably right, yes.

Q. And you understood that at the time, didn't you?

A. Understood what, that somebody was expecting a higher offer?

Q. Yes.

A. I think I probably did, yes.

(Tr. 152-153).

Thus, the fact that investors repeatedly paid more for Microdot stock than the maximum price proposed by General Cable reflected a general acknowledgment by market investors of the potential for a white knight bid. Respondents' statements simply did not mislead the market. Rather, the market acted at all times with full knowledge of the potential for a white knight bid.

REASONS FOR DENYING THE WRIT

I

THE SEVENTH CIRCUIT'S DECISION CORRECTLY AFFIRMED THE DISTRICT COURT'S JUDGMENT UNDER WELL-SETTLED LAW AND THE FACTS OF THIS CASE, AND THE DECISION IS NOT IN CONFLICT WITH ANY OTHER COURT OF APPEALS DECISION

A. Regardless Of The Manner In Which this Court Decides *Basic, Inc. v. Levinson,* The Decision Of The Court Of Appeals In This Case Is Correct

The principle ground asserted by Flamm in support of the Petition is that this Court's decision in *Basic, Inc. v. Levinson,* (No. 86-279), will be dispositive of the appeal in this case. Microdot and Eberstadt respectfully submit, however, that regardless of the manner in which this Court decides *Levinson,* the Seventh Circuit's decision in this case is entirely correct and raises no issues worthy of this Court's attention.

Levinson presents this Court with the question of when a corporation must disclose information which is otherwise unknown to the investing public. By contrast, the decision in this case did not rest upon that issue. Rather, the decision rested squarely on two undisputed facts: (a) Microdot's disclosures were sufficient to alert investors to the possibility of a white knight bid; and (b) as a result of those disclosures, as well as general market information, investors knew that a white knight bid could occur.[3]

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[3] It is well settled that a corporation need not disclose information which is already known to the investing public. *Seibert v. Sperry Rand Corporation,* 586 F. 2d 949, 952 (2d Cir. 1978); *Securities and Exchange Commission v. Coffey,* 493 F. 2d 1304, 1313 (6th Cir. 1974), *cert. denied,* 420 U.S. 908, 95 S.Ct. 826

(Footnote continued on the following page)

In light of those conclusive facts established at trial, the question posed in *Levinson* (i.e. a duty to disclose information which is unknown to the investing public), was entirely irrelevant to the resolution of this case. In this case, the investing public (including Flamm) knew that there could be a white knight bid for Microdot. Since the information at issue was already possessed by the investing public, no further disclosure duty can or should be imposed upon Respondents in this case.

B. A Public Corporation Which Has Given Good Investment Counsel To Its Stockholders Should Not Be Held Liable For Damages Under The Securities Exchange Act.

Throughout the course of this lawsuit's eleven-year history, Respondents have maintained that it presents a curious paradox. Petitioners are complaining because they failed to follow Respondents' good investment advice. As the Seventh Circuit correctly observed, Microdot gave its stockholders only one piece of investment advice:

> The only concrete advice Microdot gave its investors was not to sell, because $ 17 was too low. As things turned out, that was wise counsel. Flamm is hardly in a position to contend that because he rejected this advice he has been deceived.

(814 F. 2d at 1179).

Respondents submit that, notwithstanding the legal issues which Flamm asks this Court to address, resolution of this case turns on one fundamental and conclusively proven fact -- Respondents neither misled nor otherwise

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3 *(Continued)*

(1975); and *Warner Communications, Inc. v. Murdoch*, 581 F. Supp. 1482, 1492-1493 (D. Del. 1984). The Seventh Circuit's decision in this case is merely an application of that principle.

deceived Microdot investors.[4] The following passage from the Court of Appeals' concurring opinion underscores the conclusive nature of the fact that Respondents' public statements were honest:

> I would merely hold that on the specific facts of this case there has been no nondisclosure or misrepresentation from which a reasonable jury could conclude that the securities laws had been violated. The evidence, as the majority has reviewed it, supports this conclusion, and that is all we are required to decide.

(814 F. 2d at 1182).

Thus, the legal questions presented in the Petition, though perhaps of academic interest, are simply not dispositive of this case. Resolution of this case rests upon unchallenged factual findings which led both the jury and Seventh Circuit to conclude that Respondents did not defraud Microdot investors. *Lucas v. Florida Power & Light Co.*, 765 F. 2d 1039 (11th Cir. 1985). This case simply does not merit Supreme Court review.

II

THE COURT OF APPEALS DESCRIBED THE PROPER STANDARD FOR MEASURING PLAINTIFFS' DAMAGES

Since the Court of Appeals properly affirmed the district court's judgment in favor of Respondents, this Court

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[4] Petitioners' Question Number 2 asks whether a disclosure duty should be imposed upon a corporation which makes some statement other than "no corporate development." In this case, however, the Seventh Circuit examined Respondents' public statements and found that Petitioners' efforts to interpret those statements in a misleading fashion were unreasonable. Thus, the Court of Appeals specifically found that Respondents made no statements concerning "searching for higher bids" that could create a duty to disclose. It was upon this basis that the court distinguished *Levinson*. (814 F.2d at 1179).

need not reach the question raised by Petitioners regarding the measure of damages. Assuming, *arguendo*, that the issue is reached, it is not worthy of this Court's consideration. The Seventh Circuit's opinion referenced in passing the burden which a plaintiff must sustain in order to establish damages in a case of this type. The Seventh Circuit observed that:

> The usual measure of damages in a case under Rule 10b-5 is the difference between what the stock fetched and what it would have been worth had all of the information been disclosed.

(814 F. 2d at 1179).

This general statement comports in all respects with existing case authority under the Federal securities laws. In fact, in *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 92 S.Ct. 1456 (1972), this Court described the measure of damages under the Securities Exchange Act in almost identical terms:

> In our view, the correct measure of damages under § 28 of the Act, 15 U.S.C. §78bb(a), is the difference between the fair value of all that the mixed-blood seller received and the fair value of what he would have received had there been no fraudulent conduct . . . .

406 U.S. at 155.

After describing the generalized standard, the Seventh Circuit noted that Petitioners may have failed to meet their evidentiary burden at trial. Specifically, the court noted that Petitioners had failed to produce evidence of the fair value of what they would have received for their Microdot shares had there been no allegedly fraudulent conduct.[5] The court did not decide, however, that Peti-

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[5] Petitioners suggest that they are entitled to demonstrate that their stock would have been worth $ 21.00 per share. While this

(Footnote continued on the following page)

tioners were barred from recovering damages. Rather, it merely identified the quantum of proof which Petitioners must adduce in order to demonstrate the measure of damages to which they claim entitlement.

Since no specific conclusion was drawn by the Court of Appeals, Petitioners will be entitled to present proof of the full measure of damages which they claim in the event that: (a) this case is remanded for retrial; and (b) Petitioners prevail upon the merits. Thus, Flamm's claim that the Court of Appeals created an improper standard for measuring damages misinterprets the court's discussion of this issue. The court merely highlighted the fact that, without proof of actual damages caused by the fraud, monetary damages may not be recovered.

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5 *(Continued)*

may be correct, the Seventh Circuit's opinion merely highlighted additional factors which the jury could consider in making this factual determination. *See In re Warner Communications Securities Litigation*, 618 F. Supp. 735, 744-745 (S.D.N.Y. 1985), *aff'd*, 798 F. 2d 35 (2d Cir. 1986); *Beissinger v. Rockwood Computer Corporation*, 529 F. Supp. 770, 788-790 (E.D. Pa. 1981); and *J.G. Rubinstein v. IU International Corporation*, 506 F. Supp. 311, 317-318 (E.D. Pa. 1980).

CONCLUSION

For the reasons stated, the Petition for a Writ of Certiorari should be denied.

GERALD D. SKONING*
ANDREW R. LAIDLAW
EDWARD J. KARLIN
SEYFARTH, SHAW, FAIRWEATHER
& GERALDSON
Suite 4200
55 East Monroe Street
Chicago, Illinois 60603
(312) 346-8000

Attorneys for Respondents

**Counsel of Record*

APPENDIX

Wall Street Journal
Mon. Dec. 8

Attention Microdot Stockholders

Dear Fellow Shareowner:

I have some good news for you. Microdot's Board of Directors today declared a quarterly dividend of $.25 a share. The dividend is payable March 1, 1976, to shareholders of record February 2, 1976. This represents a 67% increase over the $.15 a share quarterly dividend paid during 1975 and is the fourth dividend increase in four years. This new rate represents a 150% increase over dividends in 1972.

The increase was in accordance with the policy of Microdot's Board, established in mid–1973 to increase dividends whenever earnings prospects warrant such action.

As you may remember, we have in the past declared dividend increases at January Board meetings but we felt you should know about this increase now in view of what it indicates for our earnings prospects in 1976.

Some of you may have seen an announcement in the press of a possible tender offer by a company called General Cable. Your Board of Directors has voted unanimously to recommend that you reject this offer if it ever gets off the ground. The news release makes our position clear. I want to write you a very careful and detailed analysis of why this General Cable proposal is not in your interests. But the far more important thing for you to bear in mind is that *right now no action of any kind is called for on your part.* The offer is of an uncertain nature as of right

now. I will keep you further closely advised and try to be as helpful with advice as I can.

Sincerely yours,
/s/ R. EBERSTADT, JR.

R. Eberstadt, Jr.
President and Chief
Executive Officer

December 5, 1975

STOP AND THINK

If your broker urges you to sell your shares, ask yourself if he is more interested in the commission he will make on your stock (and on your possible re-investment of funds) than he is in your welfare.

NEWS RELEASE

GREENWICH, CONNECTICUT, Dec. 5, 1975 – Microdot Inc. announced today that its Board of Directors voted unanimously to recommend rejection of General Cable's proposed tender offer for Microdot. The company said no officer or director or Microdot will tender any shares in response to the offer.

Rudolph Eberstadt, Jr., President and Chief Executive Officer of Microdot said, "We believe that the action of General Cable in announcing its offer without seeking to discuss our stockholders' interests with management is cynical and unethical and raises serious questions about their true motive. After careful consideration of the proposed offer and consulting with Goldman, Sachs & Co., our investment bankers, we have concluded that the General Cable offer is totally inadequate. We will employ all resources at our disposal to defeat the offer."

Mr. Eberstadt emphasized Microdot's intention to ini-

tiate legal proceedings to determine the propriety of the actions of General Cable and its management and directors. He also referred to antitrust questions raised by the offer, including the affiliation between General Cable and a major British cable producer which is presently subject to an order of a Federal court in New York.

Mr. Eberstadt said that General Cable's president in a meeting with Microdot's management after the announcement of the tender had admitted he knew little about Microdot's business but had held out the promise that Microdot's management would be one of the " more important assets they would want to obtain" if they were successful in their tender.

"We believe this makes clear," Mr. Eberstadt said, "that our recommendation to our stockholders is not based on any desire to save our jobs."

Finally, Mr. Eberstadt noted that the General Cable offer cannot proceed prior to a hearing before the Ohio Division of Securities which has been scheduled for December 12, 1975. Details necessary to permit Microdot stockholders to understand and evaluate the offer will not be available until after the hearing.

In the event that trading is resumed and the offer is eventually made, Mr. Eberstadt said stockholders would have plenty of time to consider whether the offer was really in their interests.

No. 87-191

Supreme Court, U.S.
FILED
AUG 31 1987
JOSEPH F. SPANIOL, JR.
CLERK

In The Supreme Court of the United States

October Term, 1987

ANN FLAMM and ARNOLD FLAMM, on behalf of a class,

Petitioners,

v.

RUDOLPH EBERSTADT, JR., and MICRODOT, INC.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

SUPPLEMENTAL APPENDIX

MICHAEL MARTIN MULDER
(Counsel of Record)
THOMAS R. MEITES
JULIANNE C. SHIPTON
MEITES, FRACKMAN & MULDER
135 South LaSalle Street
Suite 1611
Chicago, Illinois 60603
(312) 263-0272

A. BRADLEY EBEN
230 West Monroe
Room 2220
Chicago, Illinois 60606
(312) 977-0070

Attorneys for Petitioners Ann Flamm and Arnold Flamm

Pandick Technologies, Inc., Chicago • (312) 236-0200

INDEX

Page

Memorandum Opinion, United States District Court, October 19, 1976 . . . . . 1a

Memorandum Opinion, United States District Court, December 7, 1976 . . . . . 9a

Order, United States Court of Appeals, January 25, 1977 . . . . . 11a

Opinion, United States Court of Appeals, August 31, 1977 . . . . . 13a

Memorandum Opinion, United States District Court, December 30, 1977 . . . . . 33a

Opinion, United States Court of Appeals, October 23, 1978 . . . . . 41a

Memorandum Opinion, United States District Court, July 22, 1981 . . . . . 52a

Memorandum Opinion, United States District Court, March 5, 1982 . . . . . 62a

Memorandum Opinion, United States District Court, September 8, 1982 . . . . . 71a

Memorandum Opinion, United States District Court, May 23, 1983 . . . . . 73a

Order Denying Motion For Summary Judgment, United States District Court, March 18, 1986 . . . . . 79a

UNITED STATES DISTRICT COURT,
N.D. IILLINOIS, E. D.

Oct. 19, 1976.

Ann FLAMM and Arnold M. Flamm,
Plaintiffs,

v.

Rudolph EBERSTADT, Jr., and Microdot, Inc.,
Defendants.

No. 76 C 427.

MEMORANDUM OPINION

FLAUM, District Judge:

Plaintiffs, Ann and Arnold M. Flamm, are co-trustees of a trust which purchased and sold shares of stock of defendant Microdot, Inc. The complaint alleges that during the period beginning on December 5, 1975 and ending on January 23, 1976 the defendants made false and material misstatements or omissions in connection with the sale of Microdot common stock during the pendency of a tender offer by General Cable Corp., in violation of the Securities Exchange Act of 1934, §§ 10(b), 14(e), 15 U.S.C. §§ 78j(b), n(e). Plaintiffs seek damages for themselves as well as the right to represent a class composed of:

> All sellers of the common stock of Microdot, Inc. during the period beginning on December 5, 1975 and ending at the close of business on January 23, 1976, excluding the defendants and those in concert with them.

Before the court are plaintiffs' and defendants' motions raising the question of whether or not this cause should proceed as a class action. Rule 23(a) of the Federal Rules of Civil Procedure provides:

> (a) Prerequisites to a Class Action. One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

While defendants argue that plaintiffs have failed to establish several of the abovementioned criteria, it is the fourth requirement of fair and adequate representation that the defendants urge as the primary reason for why class certification in this cause, at this time, would be inappropriate.

Defendants' argument for why plaintiffs in this cause will not fairly and adequately protect the interests of the class they seek to represent is premised upon certain undisputed facts. It appears that Arnold M. Flamm is an attorney practicing in partnership with Arthur T. Susman, one of the two attorneys of record for plaintiffs in this cause, in a firm named Prins, Flamm and Susman, Ltd. The second attorney of record, Thomas R. Meites, is a private practitioner who rents and shares office space in the same suite as is occupied by plaintiff's firm. Moreover, the second plaintiff in this suit, Ann Flamm, is the mother of Arnold M. Flamm. Finally, it appears that the recovery to be had by the individual plaintiffs in this case will be much less than the possible attorney's fees generated by the prosecution of this suit as a class action.[1]

Defendants contend that these facts demonstrate that

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[1] The recovery to the individual plaintiffs will be approximately $800. However, it should be further noted that plaintiffs sue in their capacity as trustees of an inter-vivos trust so that they themselves may not receive any form of recovery at the termination of this action.

the plaintiffs will be faced with a conflict of interest which could or will prevent them from fairly and adequately representing the interests of the proposed class. Thus, defendants argue, because of the minimal recovery which the plaintiffs seek individually, plaintiffs may be inclined to act in such a way as to maximize the return from this suit to their associates who are representing them, a return which Arnold Flamm might share in as a member of his attorney's law firm. Moreover, defendants suggest that if Arnold Flamm is represented by his own law firm ethical considerations might foreclose the possibility of him testifying in this cause to the detriment of the class he seeks to represent.

It should be noted at the outset that the burden is on the plaintiff seeking class certification to establish that he will fairly and adequately represent the interests of the proposed class. *Albertson's, Inc. v. Amalgamated Sugar Co.*, 503 F.2d 459, 463 (10th Cir. 1974); *Cullen v. United States*, 372 F.Supp. 441, 445 (N.D.Ill.1974); *Graybeal v. American Savings & Loan Assoc.*, 59 F.R.D. 7, 13 (D.D.C.1973). Moreover, it is the obligation of this court in determining whether or not the named plaintiffs are proper representatives of the proposed class to minimize as much as practicable the potentiality that the named plaintiffs' interests will be antagonistic to the interests of the class. *Phillips v. Klassen*, 163 U.S.App.D.C. 360, 502 F.2d 362, 365-66, *cert. denied*, 419 U.S. 996, 95 S.Ct. 309, 42 L.Ed.2d 269 (1974); *Schy v. Susquehanna Corp.*, 419 F.2d 1112, 1117 (7th Cir.), *cert. denied*, 400 U.S. 826, 91 S.Ct. 51, 27 L.Ed.2d 55 (1970). *Cf. Cullen v. United States*, *supra* at 447-48.

While it is true that the Seventh Circuit has yet to pass on the question of whether or not it is appropriate for an attorney to represent himself in a suit and at the same time attempt to represent a class, or whether such an

attorney may have his law associates represent him,[2] many other courts have disapproved of such practices. *See, Conway v. City of Kenosha*, 409 F.Supp. 344 (E.D.Wisc.1975) (plaintiff represented himself); *Seiden v. Nicholson*, 69 F.R.D. 681 (N.D.Ill.1975) (plaintiff represented himself); *Stull v. Pool*, 63 F.R.D. 702 (S.D.N.Y. 1974) (plaintiff was wife of attorney of record); *Graybeal v. American Savings & Loan Assoc.*, 59 F.R.D. 7 (D.D.C.1973) (plaintiff represented himself); *Cotchett v. Avis Rent A Car System, Inc.*, 56 F.R.D. 549 (S.D.N.Y.1972) (plaintiff member of firm representing him); *Shields v. Valley Nat'l Bank of Arizona*, 56 F.R.D. 448 (D.Ariz. 1971) (plaintiff represented himself); *Shields v. First Nat'l Bank of Arizona*, 56 F.R.D. 442 (D.Ariz.1972) (plaintiff represented himself); *Kriger v. European Health Spa, Inc.*, 56 F.R.D. 104 (E.D.Wisc.1972) (plaintiff member of firm representing him). *Cf. Eovaldi v. First Nat'l Bank of Chicago*, 57 F.R.D. 545 (N.D.Ill.1972) (class certified even though plaintiff sought to act as co-counsel since other attorneys also sought to represent the class); *Sommers v. Abraham Lincoln Federal Savings & Loan Ass'n*, 66 F.R.D. 581 (E.D.Penn.1975) (class certified even though plaintiff 's firm represented him because other independent plaintiffs were also named). In its research, this court has found only two cases which have directly allowed an attorney, or his firm, to represent himself as a class representative. *Umbriac v. American Snacks, Inc.*, 388 F.Supp. 265 (E.D.Penn. 1975) (plaintiff member of firm representing him); *Lamb v. United Security Life Co.*, 59

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[2] It should be noted that the Seventh Circuit has had called to its attention such a situation. In *Goldman v. First Nat'l Bank of Chicago*, 532 F.2d 10 (7th Cir. 1976), the court stated in a footnote that, "Goldman's withdrawal as counsel in the case removed the judge's major objection to his acting as the representative party for the class." *Id.* at 15 n. 6. All that can be said about this statement is that the Seventh Circuit did not disapprove of the district court's concern with having a lawyer being the class representative and counsel in the cause.

F.R.D. 25 (S.D.Iowa 1972) (plaintiff representing himself).

This court is in agreement with the vast majority of other courts that such an arrangement, whereby a plaintiff seeks to represent a class and act as his own attorney or retains his own law firm or associates places a millstone around the plaintiff's neck which might prevent him from properly representing the proposed class. As pointed out by the court in *Graybeal v. American Savings & Loan Assoc.*, *supra*,

> Plaintiffs have placed themselves in the dual roles of attorneys for, and representatives of, the proposed class. These dual roles are inherently fraught with potential conflicts of interests. In any class action there is always the temptation for the attorney for the class to recommend settlement on terms less favorable to his clients because a large fee is part of the bargain. The impropriety of such a position is increased where, as here, the attorney is also the representative who brought the action on behalf of the class, and where, as here, the potential recoveries by individual members, including representatives, of the class are likely to be very small in proportion to the total amount of recovery by the class as a whole. Thus plaintiffs may stand to gain little as class representatives, but may gain very much as attorneys for the class.

Id. at 13-14. Moreover, the court in *Kriger v. European Health Spa, Inc.*, *supra*, has pointed out the evidentiary problem which might arise if the proposed class representative seeks to testify in the cause:

> [A] burdensome ethical question would be raised if the plaintiff were to be called as a witness while his firm is employed in the matter. The plaintiff responds that he can pursue the matter without testifying, or, if he should be required to testify, his employers can withdraw as counsel. I find the latter solution unsatisfactory. A person wishing to represent a class must be able to demonstrate "the forthrightness and vigor . . . which the repre-

> sentative party can be expected to assert." . . . This plaintiff has commenced an action under a disability that no other member of the class is likely to have–an inability to testify except at the cost of withdrawal of counsel familiar with the case from its inception. It is not enough to say that his testimony may not be needed; the possibility of such a need makes him less capable of adequate representation than others in the class.

Id. at 105-06 (citation omitted).

This court recognizes the importance of class actions as a mechanism by which those who have suffered small injuries can band together for the purpose of vindicating their rights. Just recently, in an unpublished memorandum opinion, this court certified a class in a 10b-5 action where all elements for class certification were met. *Shofstall v. Allied Van Lines*, No. 74 C 2067 (N.D.Ill., July 8, 1976). However, this court also recognizes that class actions have the potential for abuse so as to make them more a vehicle for enrichment of the private bar rather than a tool to prevent unlawful activity. *See In re Hotel Telephone Charges*, 500 F.2d 86, 91 (9th Cir. 1974). Class actions have been criticized, moreover, because they tend to raise ethical questions concerning the solicitation of law suits by attorneys. *See Kramer v. Scientific Control Corp.*, 534 F.2d 1085 (3d Cir., 1976). Arrangements such as the one presently before the court can only add support for the critics who wish to see class actions limited. Furthermore, this court cannot agree with some that if there are any possible abuses which could occur when the class representative is a member of the firm which seeks to represent the class in the law suit that the court, as guardian of the class, can adequately police and protect the class' interests. *See, e.g., Lamb v. United Security Life Co.*, 59 F.R.D. 25, 31 (S.D. Iowa 1972). The court, as a protector under rule 23(c), can never replace an aggressive and interested plaintiff who seeks vindication of his rights. The plaintiff must truly be interested in the "outcome" of

the litigation so that the class can properly have two protectors of its interests. *See In re Goldchip Funding Co.*, 61 F.R.D. 592 (M.D.Penn. 1974).

Therefore, this court finds that when the class representative is a close professional associate with the attorney of record in the cause, the class representative can not adequately and fairly represent the class and certification should be denied. Plaintiffs herein raise several arguments, which need little comment, as to why this rule need not apply here. First, plaintiffs argue that Ann Flamm is a totally independent class representative not faced with any conflict of interests. However, Ms. Flamm is the mother of Arnold Flamm and as such can not be characterized as a totally independent class representative. Moreover, Ms. Flamm sues as a trustee, and as the defendants point out, she could not have filed her action without also joining Arnold Flamm. Second, plaintiffs contend that although Mr. Meites does share office space with Arnold Flamm's firm of Prins, Flamm and Susman, Ltd., that Mr. Meites is completely independent of and not professionally associated with plaintiff Flamm's law firm. While it may be true that there is no "legal" relationship between Mr. Meites and Mr. Flamm, this court is aware that legal work is done in which Mr. Meites collaborates with the firm of Prins, Flamm and Susman, Ltd. *See, e.g., Susman v. Lincoln American Corp.*, No. 73 C 1089 (N.D.Ill., filed April 26, 1973) (a case also seeking class certification and where both the firm of Prins, Flamm and Susman, Ltd., and Mr. Meites are attorneys of record).

Third, plaintiffs argue that Mr. Flamm has waived any interest in fees and therefore there is in fact no conflict of interest. But, as defendants point out, the firm of Prins, Flamm and Susman, Ltd., is a professional service corporation organized under the laws of the State of Illinois and therefore such a waiver is not possible. While the plaintiffs

have not responded to this point, all the court need state is that it is the spectre of conflict of interest which moves the court to deny class certification here and not the actuality of such a conflict. And finally, plaintiffs raise the argument that it seems strange for the defendants, who would rather see no law suit in this case, to argue for the protection of the class. *See Umbriac v. American Snacks, Inc.*, 388 F.Supp. 265, 275 (E.D.Pa.1975). However, the manner in which the fact of inappropriate representation is presented to the court is immaterial to the requirement that plaintifs must establish that they are proper representatives.

In conclusion, the court wishes to indicate that there has been no act of impropriety committed by any of the plaintiffs or their attorneys. Moreover, the court wishes to indicate that it is not saying that in an ordinary case a plaintiff can not be represented by a close professional associate. All the court is saying is that a class action cannot be maintained in an action such as this since the requirements of rule 23(a)(4) have not been met. Plaintiffs can seek different counsel if they so desire to dispel any possibility of conflict of interest. Thus, this lawsuit may continue; it may not however, at this time, proceed as a class action.

It is so ordered.

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

ANN FLAMM and ARNOLD M. FLAMM,
Plaintiffs,

v.

RUDOLPH EBERSTADT, JR., and MICRODOT, INC.,
Defendants.

76 C 427

MEMORANDUM OPINION

JOEL M. FLAUM, District Judge:

Before the court is plaintiff's motion for reconsideration, or in the alternative for certification pursuant to 28 U.S.C. § 1292(b), of this court's October 19, 1976 ruling. First, plaintiff's motion for reconsideration is denied. Second, the motion for certification is granted.

This court believes that certification of its October 19, 1976 ruling is appropriate for several reasons. First, as a practical matter, the question of law decided by this court may be determinative of this cause since the expected recovery by the plaintiffs is relatively small and might not justify the continued prosecution of this suit. Thus, a controlling question of law has been decided and an appeal at this time will materially advance the ultimate termination of the litigation. Second, although this court is of the opinion that the rule enunciated in the October 19, 1976 decision is the better and most appropriate resolution of the legal and ethical considerations posed, there does exist differences as to the proper approach to be taken in this area. Moreover, neither the Seventh Circuit nor any other court of appeals has decided the issues presented in this cause, particularly in the context of a petition for class certification. Third, and most important, the issues decided

by this court may have extensive effect upon the prosecution of many class actions presently pending in the district courts.[1] The matters raised in the October 19, 1976 ruling touch not only questions concerning the prosecution of class actions, but are relevant as well to the moral and ethical obligations of attorneys bringing such suits.

Therefore, for the foregoing reason this court certifies for present appeal the October 19, 1976 ruling in this cause.

It is so ordered.

/s/ JOEL M. FLAUM
United States District Judge

Dated: December 7, 1976

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[1] As of June 30, 1976, there were 489 class action suits pending in the Seventh Circuit alone. Administrative Office of the United States Courts, 1976 Annual Report of the Director 122, table 38 (1976).

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
CHICAGO, ILLINOIS 60604

January 25, 1977

Before

Hon. LUTHER M. SWYGERT, Circuit Judge
Hon. WILLIAM J. BAUER, Circuit Judge
Hon. HARLINGTON WOOD, JR. Circuit Judge

ANN FLAMM and ARNOLD FLAMM, Misc. No. 76-8119
Plaintiffs-Appellants,

vs.

RUDOLPH EBERSTADT, JR. and MICRODOT, INC.,
Defendants-Appellees

MICHAEL SUSMAN, Misc. No. 77-8003
Plaintiff-Appellant

vs.

LINCOLN AMERICAN CORP., et al,
Defendants-Appellees

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division

No. 76 C 427
No. 73 C 1089

Judge Flaum

These matters come before this Court on the filing herein of the separate documents entitled "PETITION FOR PERMISSION TO APPEAL" by counsel for the plaintiffs-appellants. Counsel for the different sets of defendants filed separate answers in opposition thereto. Upon a thorough consideration of the documents filed herein, this Court being fully advised in the premises,

IT IS ORDERED that the plaintiffs-appellants in each of these cases are hereby GRANTED permission to appeal from the interlocutory orders of the District Court in accordance with the provisions of 28 U.S.C. 1292(b).

IT IS FURTHER ORDERED that these two matters be CONSOLIDATED, upon docketing, for procedural purposes in this Court.

UNITED STATES COURT OF APPEALS, SEVENTH CIRCUIT.

Michael SUSMAN,
Plaintiff-Appellant,

v.

LINCOLN AMERICAN CORP. et al.,
Defendants-Appellees.

Ann FLAMM and Arnold Flamm,
Plaintiffs-Appellants,

v.

Rudolph EBERSTADT, Jr. and Microdot, Inc.,
Defendants-Appellees.

Nos. 77-1145, 77-1146.

Argued April 27, 1977.
Decided Aug. 31, 1977.

Before PELL, BAUER and WOOD, Circuit Judges.

HARLINGTON WOOD, Jr., Circuit Judge.

In the two cases consolidated for our consideration, appellants contest the validity of the district court's judgment denying certification of their class action.[1] In each case the district judge ruled pursuant to Fed.R.Civ.P.

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[1] This court on January 25, 1977, granted appellants permission to appeal pursuant to 28 U.S.C. § 1292(b). This court also ordered on January 25, 1977, that the two cases be consolidated on appeal for procedural purposes.

23(a)(4)[2] that the class representative would not fairly and adequately protect the interests of the class. For the following reasons, the judgment of the district judge is affirmed.

The facts in these cases are as follows:

1. The Microdot case.

Plaintiffs-Appellants Ann Flamm and Arnold Flamm (hereinafter referred to as plaintiffs) are co-trustees of a trust which purchased and sold shares of defendant Microdot, Inc.'s stock. Plaintiffs' complaint generally alleges that defendants made false and material misstatements or omissions in connection with the sale of Microdot common stock during the pendency of a tender offer by General Cable Corporation in violation of the Securities Exchange Act of 1934, §§ 10(b), 14(e), 15 U.S.C. §§ 78j(b), 78n(e). Plaintiffs sought to represent a class composed of:

> All sellers of the common stock of Microdot, Inc. during the period beginning on December 5, 1975 and ending at the close of business on January 23, 1976, excluding the defendants and those in concert with them.

Defendants opposed certification of the class on the grounds that plaintiffs would not fairly and adequately protect the interests of the class. The district court summarized the following undisputed facts as forming a basis for defendants' objection: 1) plaintiff Arnold M. Flamm is an attorney practicing with Arthur T. Susman, one of the

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[2] Fed.R.Civ.P. 23(a) enumerates four prerequisites to a class action:

> One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

two attorneys of record for plaintiffs, in a law firm named Prins, Flamm, and Susman, Ltd.; 2) plaintiff Ann Flamm is the mother of Arnold M. Flamm; (3) Thomas R. Meites, the second attorney of record of plaintiffs, rents and shares office space in the same suite of offices as is occupied by Prins, Flamm, and Susman, Ltd.; and 4) the potential recovery for individual plaintiffs of $800.00 is much less than attorney's fees which could be generated by this lawsuit. The district judge also noted that since plaintiffs are suing in their capacity as trustees of an inter-vivos trust, they would not receive any form of recovery at the termination of this case.

The district court ruled "that when the class representative is a close professional associate with the attorney of record in the cause, the class representative cannot adequately and fairly represent the class and certification should be denied." The district judge based this ruling on several policy considerations. First, the district court ruled that since potential recovery from attorney's fees greatly exceeds possible individual recovery, plaintiffs' role as class representative and interest in the law firm which would represent the class gives rise to a possible conflict of interest. The district court also pointed to an ethical question which would arise if plaintiff Arnold M. Flamm were to be called as a witness while his firm is employed as class attorney. Similarly, citing ethical questions concerning the solicitation of lawsuits by attorneys, the lower court noted that arrangements such as exist in the present case can only add support for the critics who wish to see class actions limited. Finally, the district judge rejected the argument that since the court could protect the class from any abuse which might occur by reason of the relationship between plaintiff and counsel, the requirements of Rule 23(a)(4) should not be strictly applied. Instead, the court ruled that an aggressive and interested class representative is required under Rule 23(a)(4).

The district judge also rejected defendants' argument that these policy considerations do not apply to Ann Flamm. First, the court pointed out that since Ann Flamm is the mother of Arnold M. Flamm, she cannot be characterized as totally independent. In addition, because the suit was filed by plaintiffs as co-trustees of an inter-vivos trust, the district judge stated that Ms. Flamm could not have filed suit without joining Arnold M. Flamm. Similarly, although there is no "legal" relationship between Mr. Meites and Mr. Flamm, the lower court stated that Mr. Meites is not independent of Mr. Flamm inasmuch as legal work is done in which Mr. Meites collaborates with the firm of Prins, Flamm, and Susman, Ltd. Finally, the lower court ruled that Arnold M. Flamm's waiver of interest in fees potentially generated by this case does not eliminate the potential for a conflict of interest. The district judge found that a conflict of interest might still exist since, as defendants pointed out, a waiver of an interest in fees may not be possible in a professional service corporation organized under the laws of the state of Illinois. The court stated:

> While plaintiffs have not responded to this point, all the court need state is that it is the spectre of conflict of interest which moves the court to deny class certification here and not the actuality of such a conflict.

2. The Lincoln American case.

Plaintiff-Appellant Michael Susman (hereinafter referred to as plaintiff) alleged in his complaint that defendants had acted deceptively and made misstatements and omissions of material facts in connection with the purchase and sale of securities and the solicitation of proxies in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b-5. Plaintiff filed suit both derivatively on behalf of Consumers National Corporation and also sought to act as representative of a class of Consumers National Corporation common stock share-

holders.

Defendants opposed plaintiff's motion for certification of the class on the grounds that plaintiff did not satisfy the requirements of Fed.R.Civ.P. 23(a)(4). The basis for defendants' motion was that plaintiff is the brother of Arthur Susman, one of two attorneys representing plaintiff. The other attorney representing plaintiff is Thomas R. Meites. As was the case in *Microdot*, Mr. Meites rents and shares office space in the same suite of offices occupied by Arthur Susman's law firm. The potential recovery for plaintiff is $500.

Relying on the same analysis as was applied in his prior decision in *Microdot*,[3] the district judge ruled that:

> where an individual plaintiff is represented by a member of his immediate family and/or one of his relatives' close associates, class certification is inappropriate since the plaintiff fails to satisfy the requirements of Fed.R.Civ.P. 23(a)(4).

Plaintiffs in both of the cases now before this court jointly argue on appeal that the district court decision,

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[3] Although plaintiff is not a member of his brother's law firm, the district judge nonetheless concluded that a possible conflict of interest exists. The lower court stated:

> Even though plaintiff does not expect to share in any attorney's fees recovered in this cause, there exists the possibility that one so situated will become more interested in maximizing the "return" to his counsel than in aggressively presenting the proposed class' claims. For example, such a party might promote and be more receptive than other potential class representatives to a settlement agreement whereby his counsel might receive a relatively large and early fee which is not, in fact, in the best interests of the proposed class. While it is true that such "quick" settlements are possible in all class actions suits, the possibilities increase where there is a close personal and/or professional relationship between the named plaintiff and the attorneys seeking to represent the class.

which they characterize as a *per se* approach, is improper. Plaintiffs assert that the adequacy of class representatives should be determined under the same rules as apply to fiduciaries acting on behalf of others in a non-class action context. Plaintiffs contend that in non-class action settings, a showing of actual danger of conflict of interest rather than the mere possibility of a conflict of interest is required to support a finding that a fiduciary will not adequately represent the interest of others. Plaintiffs argue that no actual danger of a conflict of interest exists in the present case since plaintiffs will not share in any attorney's fees which might be awarded to class counsel. Plaintiffs also contend that neither ABA Canons of Professional Ethics No. 9, nor *Kramer v. Scientific Control Corp.*, 534 F.2d 1085 (3rd Cir. 1976), *cert. denied*, 429 U.S. 830, 97 S.Ct. 90, 50 L.Ed.2d 94, a case relied upon by defendants, supports the "spectre of conflict" approach utilized by the district judge. Plaintiffs next assert that the district judge's reliance on the class representative to protect the interests of absent class members is unrealistic. According to plaintiffs, the class representative who has little knowledge of the facts of the case and relatively little at stake in the outcome of the suit inevitably relies on the class attorney. Plaintiffs assert that in reality the class attorney rather than the class representative protects the interests of the absent class members. Finally, plaintiffs point to alternative methods of protecting absent class member interests which could avoid disqualification of plaintiffs as class representatives under Rule 23(a)(4).

Prior to certification of a class, a court must find that the named representatives of the class will fairly and adequately protect the interests of the class. "Basic consideration of fairness require that a court undertake a stringent and continuing examination of the adequacy of representation by the named class representatives at all stages of the litigation where absent members will be bound by the court's judgment." *National Asso-*

ciation of Regional Medical Programs v. Mathews, 551 F.2d 340 (D.C.Cir.1976). Strict oversight is necessitated since due process requires that absent class members be adequately represented in order to be bound by a court's judgment.[4] *National Association of Regional Medical Programs*, 551 F.2d at 344-5; *Hansberry v. Lee*, 311 U.S. 32, 42-43, 61 S.Ct. 115, 85 L.Ed. 22 (1940); *Gonzales v. Cassidy*, 474 F.2d 67 (5th Cir. 1973); Wright & Miller, Federal Practice and Procedure, § 1765, p. 617. "Adequate representation depends on two factors: (a) the plaintiff's attorney must be qualified, experienced, and generally able to conduct the proposed litigation, and (b) the plaintiff must not have interests antagonistic to those of the class." *Wetzel v. Liberty Mutual Insurance Co.*, 508 F.2d 239, 247 (3rd Cir. 1975), B*cert. denied*, 421 U.S. 1011, 95 S.Ct. 2415, 44 L.Ed.2d 679;. *Eisen v. Carlisle & Jacquelin*, 391 F.2d 555, 562 (2d Cir. 1968); *Cross v. National Trust Life Insurance Co.*, 553 F.2d 1026, 1031 (6th Cir. 1977). Whether a party would adequately protect the interests of the class is a question of fact depending on the circumstances of each case. *Schy v. Susquehanna Corporation*, 419 F.2d 1112, 1116 (7th Cir. 1970), *cert. denied*, 400 U.S. 826, 91 S.Ct. 51, 27 L.Ed.2d 55; Wright &

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[4] As the court stated in *Hansberry v. Lee*, 311 U.S. 32, 42-45, 61 S.Ct. 115, 118, 85 L.Ed. 22 (1940):

> With a proper regard for divergent local institutions and interests . . . this Court is justified in saying that there has been a failure of due process only in those cases where it cannot be said that the procedure adopted, fairly insures the protection of the interests of absent parties who are to be bound by it. . . .
>
> It is familiar doctrine of the federal courts that members of a class not present as parties to the litigation may be bound by the judgment where they are in fact adequately represented by parties who are present, or where they actually participate in the conduct of the litigation in which members of the class are present as parties . . . .

Miller, Federal Practice and Procedure, § 1765, p. 622. A district judge's determination of the adequacy of representation is a matter of discretion and will not be disturbed on appeal unless abuse of discretion is shown. *Morris v. McCaddin*, 553 F.2d 866, 870 (4th Cir. 1977); *Brick v. CPC Intern., Inc.*, 547 F.2d 185 (2d Cir. 1976); Wright & Miller, Federal Practice and Procedure, § 1765, p. 623. A putative class representative has the burden of convincing the trial court that the mandatory requirements of Rule 23(a) have been satisfied. *Valentino v. Howlett*, 528 F.2d 975 (7th Cir. 1976); *Doctor v. Seaboard Coast Line R. Co.*, 540 F.2d 699, 706-707 (4th Cir. 1976); Wright & Miller, Federal Practice and Procedure, § 1765, p. 626.

The district judge found in both of the cases now before this court that plaintiffs would not adequately protect the interests of the class because of the relationship of plaintiffs to plaintiffs' counsel. The lower court's decision is supported by a majority of courts which have refused to permit class attorneys,[5] their relatives,[6] or business associ-

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[5] In the following cases, a putative class attorney was prohibited from simultaneously acting as class representative. *Seiden v. Nicholson*, 69 F.R.D. 681 (N.D.Ill. 1976); *Graybeal v. American Savings & Loan Association*, 59 F.R.D. 7 (Dist.Col. 1973); *Shields v. Valley National Bank of Arizona*, 56 F.R.D. 448 (D.Ariz.1971); *Shields v. First National Bank of Arizona*, 56 F.R.D. 442 (D.Ariz.1972); *Eovaldi v. First National Bank of Chicago*, 57 F.R.D. 545 (N.D.Ill.1972); *Conway v. City of Kenosha, Wis.*, 409 F.Supp. 344 (E.D.Wis.1975). *Contra, Lamb v. United Security Life Company*, 59 F.R.D. 25 (S.D.Iowa 1972). Although the court in *Clark v. Cameron-Brown Co.*, 72 F.R.D. 48 (M.D.N.C. 1976), allowed the same individual to act as class representative and class counsel, two additional class representatives were involved in that suit.

[6] The court in *Stull v. Pool*, 63 F.R.D. 702 (S.D.N.Y.1974), held that the wife of a member of the law firm which would act as class counsel could not qualify as class representative. See

(Footnote continued on the following page)

ates[7] from acting as the class representative.

The most frequently cited policy justification for this line of cases arises from the possible conflict of interest resulting from the relationship of the putative class representative and the putative class attorney. Since possible recovery of the class representative is far exceeded by potential attorneys' fees, courts fear that a class representative who is closely associated with the class attorney would allow settlement on terms less favorable to the interests of absent class members. *Stull v. Pool*, 63 F.R.D. 702 (S.D.N.Y.1974); *Graybeal v. American Savings & Loan Assn.*, 59 F.R.D. 7 (Dist.Col.1973). Courts also have expressed fear as to the danger of champerty because of the close relationship between the putative class representative and counsel. *Byrnes v. IDS Realty Trust*, 70 F.R.D. 608, 614 (D.Minn.1976); *Shields v. Valley National*

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6 *(Continued)*

also *Toroff v. May Co.*, 531 F.2d 1357 (6th Cir. 1976); *Bogus v. American Speech and Hearing Association*, 20 F.R.Serv.2d 859 (E.D.Pa.1975). *Contra, Sweet v. Bermingham*, 65 F.R.D. 551 (S.D.N.Y.1975); *Fischer v. International Tel. & Tel. Corp.*, 72 F.R.D. 170 (E.D.N.Y. 1976).

[7] The courts in the following cases ruled that a plaintiff associated with the putative class attorney's law firm cannot adequately protect class members interests. *Turoff v. May Co.*, 531 F.2d 1357 (6th Cir. 1976); *Brick v. CPC Intern., Inc.*, 547 F.2d 185 (2d Cir. 1976); *Kriger v. European Health Spa, Inc., of Milwaukee, Wis.*, 56 F.R.D. 104 (E.D.Wis.1972); *Cotchett v. Avis Rent A Car System, Inc.*, 56 F.R.D. 549 (S.D.N.Y.1972). See also *Kramer v. Scientific Control Corp.*, 534 F.2d 1085 (3rd Cir. 1976). *Contra, Stull v. Baker* [1973 Transfer Binder] CCH Fed.Sec.L.Rep ¶ 94,227 at ¶ 94,929 (S.D.N.Y.1973); *Umbriac v. American Snacks, Inc.*, 388 F.Supp. 265 (E.D.Pa.1975) (dicta).

In *Sommers v. Abraham Lincoln Federal Savings and L. Ass'n*, 66 F.R.D. 581 (E.D.Pa. 1975), one of each of the five plaintiff couples was employed by plaintiffs' counsel's law firm. The court concluded that inadequacies which may have existed had been cured by the intervention of numerous other named plaintiffs.

Bank of Arizona, 56 F.R.D. 448, 450 (D.Ariz.1971). Ethical considerations have also been cited as a basis for denial of class certification in these cases. Judge Gordon in *Kriger v. European Health Spa, Inc., of Milwaukee, Wis.*, 56 F.R.D. 104, 105-6 (E.D.Wis.1972), cited possible ethical questions which would be raised if the class representative were to be called as a witness while his law firm is employed in the matter:

> All parties agree that a burdensome ethical question would be raised if the plaintiff were to be called as a witness while his firm is employed in the matter. The plaintiff responds that he can pursue the matter without testifying, or if he should be required to testify, his employers can withdraw as counsel. I find the latter solution unsatisfactory. A person wishing to represent a class must be able to demonstrate "the forthrightness and vigor . . . which the representative party can be expected to assert." *Mersay v. First Republic Corp.*, 43 F.R.D. 465, 470 (S.D.N.Y.1968). This plaintiff has commenced an action under a disability that no other member of the class is likely to have – an inability to testify except at the cost of withdrawal of counsel familiar with the case from its inception. It is not enough to say that his testimony may not be needed; the possibility of such a need makes him less capable of adequate representation than others in the class.

Finally, in a different but related context, the court in *Kramer v. Scientific Control Corp.*, 534 F.2d 1085 (3rd Cir. 1976), held that a motion for disqualification of an attorney acting as class counsel should be granted pursuant to ABA Canons of Professional Ethics No. 9 where even an appearance of an improper conflict of interest exists because of the close relationship of the putative class representative and putative class attorney.

Our circuit has not yet considered the question of adequacy of representation when a close relationship exists

between plaintiff and his attorney.[8] The Second, Third and Sixth Circuits have, however, considered various aspects of this question.

In *Brick v. CPC Intern. Inc.*, 547 F.2d 185 (2d Cir. 1976), the attorney of record for the plaintiff was plaintiff's sole law partner. The district judge denied plaintiff's motion for class certification "because of concern over the ethical problems posed by the attorney-plaintiff relation-

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[8] In *Goldman v. First National Bank of Chicago*, 56 F.R.D. 587 (N.D.Ill.1972), defendant questioned the ability of plaintiff to act as class representative on the grounds that plaintiff was also acting as attorney of record. Then District Judge Bauer without ruling on the question noted the following language from *Shields v. Valley National Bank*, 56 F.R.D. 448 (N.Ariz.1972):

> The Court ... feels that Shields has not demonstrated competence to represent the class because he seeks to be not only the attorney for the class and be awarded a fee for his representation, he seeks in the same action, personal relief. The practice involved does not seem to the Court to comport with the high quality of objectivity, duty and integrity required of lawyers practicing in this Court or elsewhere. This case seems to involve a questionable method of soliciting legal business and such solicitation should not be encouraged. 56 F.R.D. at 589 n. 1.

In reversing the lower court's opinion on other grounds, this court stated on appeal:

> The requirements of section (a) of Rule 23 are satisfied as determined by the district court, *supra*, n. 4. The determination of subsection 4 of Rule 23(a) was not made explicitly in the court's opinion, but we note that Goldman's withdrawal as counsel in the case removed the judge's major objection to his acting as the representative party for the class.
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> 532 F.2d 10, 15 n. 6 (7th Cir. 1976), *cert. denied*, 429 U.S. 870, 97 S.Ct. 183, 50 L.Ed.2d 150.

ship in this case and plaintiff's 'ability and diligence to prosecute the suit as a class action.'" 547 F.2d at 186. Although declining to adopt a per se rule prohibiting class representation under the circumstances of the case, the court on appeal found that the district judge had not abused his discretion in denying class certification:

> On the issue of class representation, district courts in this circuit have expressed concern over the propriety of a law partner relationship between the attorney for the class and its representative, but they have not invariably refused to certify the class when the relationship exists. Compare *Stull v. Baker* [1973 Transfer Binder] CCH Fed.Sec.L.Rep. ¶94,227, at 94,929 (S.D.N.Y.1973), with *Cotchett v. Avis Rent A Car System, Inc.*, 56 F.R.D. 549 (S.D.N.Y.1972). And we have not yet ruled on whether, as appellee suggests here, there should be a per se rule prohibiting the practice. See *Kramer v. Scientific Control Corp.*, 534 F.2d 1085 (3d Cir. 1976); Note, Developments in the Law–Class Actions, 89 Harv.L.Rev. 1318, 1577-86, 1585 n. 29 (1976).
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> We do not think that this is a proper case for fuller consideration of these issues. It is clear from the record before us that Judge MacMahon did not abuse his discretion in denying class certification. Moreover, we note that his decision does not bar class certification with another person representing the class. Under the circumstances, we will assume arguendo that the order is appealable and affirm the district court, leaving to another day fuller discussion of the issues presented here.
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> 547 F.2d at 186-7 (footnotes omitted).

Of the four named plaintiffs in *Turoff v. May Co.*, 531 F.2d 1357 (6th Cir. 1976), "three are attorneys with the law firm of counsel and the fourth is the wife of one of them." 531 F.2d at 1360. The court ruled that the relationship between plaintiff and counsel created an inherent conflict which prohibited plaintiffs from adequately protecting the interests of the class. For purposes of determining the

adequacy of representation, the court treated plaintiffs who were members of the law firm of counsel or a spouse of a member of the law firm as being the same "person" as counsel:

> The Turoffs do not have standing to represent the class of May charge account customers similarly situated. Of the four named plaintiffs, three are attorneys with the law firm of counsel and the fourth is the wife of one of them. Rule 23(a)(4) of the Federal Rules of Civil Procedure provides that a representative party must "fairly and adequately protect the interests of the class." For the same individual to attempt representation of the class as plaintiff and as counsel presents an inherent conflict of interests. Because the financial recovery for reasonable attorney's fees would dwarf the individual's recovery as a member of the class herein, the financial interests of the named plaintiffs and of the class are not coextensive. If the interests of a class are to be fairly and adequately protected, if the courts and the public are to be free of manufactured litigation, and if proceedings are to be without cloud, the roles of class representative and of class attorney cannot be played by the same person. See *Kriger v. European Health Spa, Inc., of Milwaukee, Wis.*, 56 F.R.D. 104 (E.D.Wis.1972); *Shields v. First National Bank of Arizona*, 56 F.R.D. 442 (D.Ariz.1972); *Shields v. Valley National Bank of Arizona*, 56 F.R.D. 448 (D.Ariz.1971); *Cotchett v. Avis Rent A Car System, Inc.*, 56 F.R.D. 549 (S.D.N.Y.1972); *Eovaldi v. First National Bank of Chicago*, 57 F.R.D. 545 (N.D.Ill.1972); *Graybeal v. American Savings & Loan Association*, 59 F.R.D. 7 (D.C.D.C.1973); *Berkman v. Sinclair Oil Corporation*, 59 F.R.D. 602 (N.D.Ill.1973); *Shibley v. Time, Inc.*, 40 Ohio Misc. 51, 321 N.E.2d 791 (Cuy.Co.C.P.1974); *Stull v. Pool*, 63 F.R.D. 702 (S.D.N.Y.1974).
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> 531 F.2d at 1360.

The court in *Kramer v. Scientific Control Corp.*, 534 F.2d 1085 (3rd Cir. 1976), ruled that the Code of Professional Responsibility requires that:

> . . . no member of the bar either maintaining an employment relationship, including a partnership or professional corporation, or sharing office or suite space with an attorney class representative during the preparation or pendency of a Rule 23(b)(3) class action may serve as counsel to the class if the action might result in the creation of a fund from which an attorneys' fee award would be appropriate.

534 F.2d at 1093.[9]

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[9] The court in *Kramer* ruled that the district judge's order certifying the class action was unreviewable since it was an interlocutory order. The court held, however, that the district judge had erred in treating defendants' subsequent motion to disqualify plaintiffs' counsel merely as reargument of the certification question. The court stated:

> As previously rehearsed, page 1087 *supra*, in this case the district court treated the motion to disqualify counsel as a motion to reconsider the class action certification decision. The issue on certifying plaintiffs as class representatives—whether they would "fairly and adequately protect the interests of the class", F.R.Civ.P. 23(a)(4), when their counsel was an employee (and later a partner) in Kramer's firm—was related, but not identical, to the issue posed by the disqualification motion. Reducing the distinction to its bare essentials, the former issue relates to who may serve as class representative, while the latter relates to who may serve as counsel. The trial court failed to perceive the difference and consequently erred. 534 F.2d at 1088.

The court found that denial of the motion to disqualify plaintiffs' attorney was appealable under the collateral rule of *Cohen v. Beneficial Industrial Loan Corp.*, 337 U.S. 541, 69 S.Ct. 1221, 93 L.Ed. 1528 (1949).

Although, as the court in *Kramer* pointed out, the disqualification motion does not raise an issue identical to a Rule 23(a)(4) question, the policy considerations expressed by the court in *Kramer* are equally applicable in the present case. Even though we find the policy considerations expressed in *Kramer* to be applicable to the present case, this court does not adopt the absolute approach utilized in that case.

According to the court, the notion that the appearance of conduct is as important as the conduct itself is a predicate for the Code of Professional Responsibility. Thus, ABA Canons of Professional Ethics No. 9 provides: "A lawyer should avoid even the appearance of professional impropriety." Under this standard, the court ruled that it is immaterial whether plaintiff has taken precautions to ensure that he will not benefit from attorney's fees or act as an attorney in the case. Similarly, neither plaintiff's motivation in bringing the suit nor the quality of legal representation afforded by counsel are relevant. On the contrary, the factor mandating judicial inquiry is the appearance of impropriety inherent in plaintiff's role as representative of class members interests vis-à-vis plaintiff's business associate's desire to maximize recovery of attorney's fees from an equitable fund created by the court for the benefit of the class. Since the public understands a partnership to provide for sharing profits and losses, the court concluded that "[e]soteric internal protections in writing or under oath, insulating the plaintiff-attorney partner from participating in a fee, can hardly dissipate the lay notion that action by one partner is action for the partnership." 534 F.2d at 1092.

Although the cases which have been referred to offer some support for a *per se* approach, this court declines to adopt a *per se* analysis. We find, however, that the district judge did not under the circumstances of this case abuse his discretion in ruling that plaintiffs are inadequate to act as class representatives.

In *Microdot*, the joint membership of Arnold M. Flamm and Arthur T. Susman in the same law firm renders Arnold Flamm an inadequate class representative. First, the likelihood of a conflict of interest exists between Flamm's assertion of class interests and his interest in attorney's fees which might be awarded to his law firm. Although Flamm has filed an affidavit stating that he has waived

his interest in fees which might be awarded to his law firm, defendants argued before the district court and contend on appeal that Flamm's waiver of interest in attorney's fees is not possible under the Professional Service Corporation Act, Ill.Rev.Stat. ch. 32, § 415-1, *et seq.* Plaintiffs failed to respond to this point either before the district judge or on appeal. Even if plaintiff's waiver is effective, plaintiff retains both pecuniary and non-pecuniary interests in an award of attorney's fees to his law firm which would support a finding of a likelihood of a conflict of interest.[10] For example, the value of stock held by Flamm in Prins, Flamm and Susman, Ltd., might increase if the law firm

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[10] We find that *Kesselhaut v. United States,* 555 F.2d 791 (Ct.Cl.1977), a case submitted to this court by plaintiffs pursuant to Circuit Rule 11, is distinguishable from the present case. In *Kesselhaut,* the trial judge disqualified the law firm of Krooth and Altman from representing plaintiffs because A. M. Prothro, an attorney working for the law firm who had recently retired as General Counsel of the FHA, had come into contact with plaintiffs' lawsuit before he left the FHA. Prothro was not a partner in Krooth and Altman. He initially received a straight salary and later was paid hourly compensation for part-time work. Prothro disqualified himself from all contacts with the lawsuit and expected to retire prior to the time when plaintiffs' case would come to trial. On the basis of these facts, the Court of Claims, sitting en banc, reversed the trial judge's decision. The court ruled that disqualification of an entire law firm because of the prior involvement of one of its members when serving as a government attorney was too inflexible a rule. The primary policy consideration relied upon by the court was that an inflexible disqualification of an entire law firm "would act as a strong deterrent to the acceptance of Government employment by the most promising class of young lawyers." At 793.

The policy consideration relied upon by the court in *Kesselhaut* is not applicable to the case now before this court. In addition, the decision in *Kesselhaut* was made in a nonclass action context free from the requirements imposed by Rule 23(a)(4) and the due process clause in a class action context. We therefore conclude that *Kesselhaut* does not control our decision in the present case.

received a large recovery for attorney's fees. In addition, plaintiff also retains an interest in the reputation and good will of his law firm which would be enhanced by a large attorney's fee award. See *SCA Services, Inc. v. Hon. Robert D. Morgan, Judge, United States District Court for the Southern District of Illinois, et al.*, No. 77-1194, 557 F.2d 110, 115 (7 Cir. 1977). Thus, we agree with the district judge that under these circumstances the likelihood of a conflict of interest justifies denial of class certification.[11] As the court stated in *Turoff*, 531 F.2d at 1360:

> Because the financial recovery for reasonable attorney's fees would dwarf the individual's recovery as a member of the class herein, the financial interests of the named plaintiffs and of the class are not coextensive. If the interests of a class are to be fairly and adequately protected, if the courts and the public are to be free of manufactured litigation, and if proceedings are to be without cloud, the roles of class representative and class attorney cannot be played by the same person.

We also find that this possible conflict of interest must be considered in conjunction with public perception that

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[11] Plaintiffs argue that an actual conflict of interest must be shown to support a finding that the requirements of Rule 23(a)(4) have not been met. While "mere imaginative speculation" is not enough, *Robertson v. National Basketball Association*, 389 F.Supp. 867, 899 (S.D.N.Y.1975), the district court must assess the likelihood that a conflict of interest may exist. *Sosna v. Iowa*, 419 U.S. 393, 403, 95 S.Ct. 553, 42 L.Ed.2d 532 (1975); *Swain v. Brinegar*, 517 F.2d 766, 780 (7th Cir. 1975); *Phillips v. Klassen*, 163 U.S.App.D.C. 360, 502 F.2d 362, 366 (1974), *cert. denied*, 419 U.S. 996, 95 S.Ct. 309, 42 L.Ed.2d 269; *Cullen v. United States*, 372 F.Supp. 441, 448 (N.D.Ill.1974). We believe that the likelihood of a conflict of interest exists where the class representative's possible recovery is far outweighed by attorney's fees which might be awarded to a law firm in which he is a member. That relationship raises an inherent conflict of interest. See *Turoff*, 531 F.2d at 1360.

plaintiff shares in attorney's fees won by his law firm. As the court in *Kramer*, 534 F.2d at 1092, noted, "esoteric internal protections" preventing an attorney from sharing in fees awarded to his law firm do not dissipate the public's perception that plaintiff would in fact receive benefit from fees awarded to his law firm.[12] Thus, policy considerations expressed by the court in *Kramer, supra*, which have their roots in ABA Canons of Professional Ethics No. 9, also support the lower court's decision.[13]

We find for similar reasons that the district court properly concluded in *Lincoln American* that Michael Susman is under the circumstances an inadequate class representative. Michael Susman's possible recovery as plaintiff is dwarfed by attorney's fees which could be awarded to his

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[12] We do not believe that the analysis in *Kramer* is rendered inapplicable to the present case by the fact that plaintiff's law firm is organized as a professional service corporation rather than as a partnership. The court in *Kramer*, 534 F.2d at 1093, included professional service corporations within the scope of its holding.

[13] Plaintiffs rely on *International Electronics Corp. v. Flanzer*, 527 F.2d 1288 (2d Cir. 1975), for the proposition that in the absence of a violation of one of the provisions in Canons 1 through 8, Canon 9's caveat cannot be independently relied upon. Plaintiffs have, however, misread *Flanzer*. The court in *Flanzer* only cautioned against indiscriminate application of Canon 9 where the facts do not fit within Canons 1-8. The court did not set forth an inflexible prohibition on the independent use of Canon 9. The court stated:

> From what we have said, it must be clear that we do not think the question of "appearances" under Canon 9 is particularly acute in this case. We caution, as the Connecticut Bar Association urges us to do, that Canon 9, though there are occasions when it should be applied, should not be used promiscuously as a convenient tool for disqualification when the facts simply do not fit within the rubric of other specific ethical and disciplinary rules. 527 F.2d at 1295.

brother as class counsel. As the district judge stated:

> Even though plaintiff does not expect to share in any attorney's fees recovered in this cause, there exists the possibility that one so situated will become more interested in maximizing the "return" to his counsel than in aggressively presenting the proposed class' action.

In addition, the likelihood of a conflict of interest is also supported by "the natural assumption that brothers enjoy a close personal and family relationship and, consequently, would be inclined to support each other's interests." *SCA Services, Inc.*, No. 77-1194, at 116.[14]

Plaintiffs' relationship to Mr. Meites raises similar considerations. The fact that an individual rents office space from a law firm does not by itself render a member of that firm or a relative of a member of that firm an inadequate class representative. On the contrary, a court must examine the circumstances of each case. The district court's ruling which was based on the interdependence between Mr. Meites and the law firm of Prins, Flamm and Susman, Ltd., cannot be said to be an abuse of discretion.

We do not accept under the circumstances of this case plaintiffs' argument that reliance on the court's control of settlement and attorney's fees renders strict enforcement of the requirements of Rule 23(a)(4) unnecessary. Nor do we under the present circumstances agree with plaintiffs that a realistic approach to ensuring protection of absent class members' interests places principal reliance on class counsel and the court. Both Rule 23(a)(4) and

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[14] We also agree with the district court that Ann Flamm is not by herself an adequate class representative. As the district court pointed out, Ann Flamm is also subject to a conflict of interest analysis because of her relationship as the mother of Arnold Flamm. In addition, the district court found that Ms. Flamm as co-trustee could not have brought this suit without also joining her son as plaintiff.

the due process clause require that representative parties adequately protect the interests of absent class members. The entire process of adjudication which is comprised of the class representative, class counsel, and the trial judge must ensure adequacy of representation. *National Ass'n of Regional Medical Programs*, 551 F.2d at 346; Developments in the Law—Class Actions, 89 Harv.L.Rev. 1321, 1410-11 (1976).[15] We find that the district judge was acting well within his discretion in strictly applying the requirements of Rule 23(a)(4) where the close relationship between plaintiff and counsel creates an inherent conflict of interest. We note, however, that judicial control over class settlements and attorney's fees might, under other circumstances, provide adequate protection for the due process rights of absent class members.

As the district judge noted, plaintiffs are free to seek different counsel and thereby dispel any possibility of a conflict of interest. In lieu of a change in counsel which might result in a certification of the class actions, plaintiffs are not barred from continuing the lawsuits on their own behalf.

By holding as we do in this case we intend no adverse reflection whatsoever, either professionally or personally, upon the individual counsel involved.

For the foregoing reasons, the rulings by the district judge in the two cases now before this court are hereby affirmed.

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[15] Citing state court cases where fiduciaries in non-class action contexts were allowed to either act as attorney or employ a member of the fiduciaries' law firm as an attorney, plaintiffs urge that a similar rule be applied to class representatives. The cases cited by plaintiffs are, however, inapposite to the present case. Strict application of the adequacy of representation requirement is mandated by due process considerations since absent class members will be bound by the court's judgment. Similar considerations were not raised in the cases cited by plaintiffs.

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

ANN FLAMM and ARNOLD M. FLAMM,
Plaintiffs,

v.

RUDOLPH EBERSTADT, JR. and MICRODOT, INC.,
Defendants.

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MEMORANDUM OPINION

JOEL M. FLAUM, District Judge:

This case was filed as a class action asserting claims under the Securities Exchange Act of 1934, §§ 10(b), 14(e), 15 U.S.C. §§ 78j(b), n(e). In an opinion dated October 19, 1976, this court issued a ruling denying plaintiffs' motion for class certification because of plaintiffs' failure to meet the requirements of Fed. R. Civ. P. 23(a)(4). *Flamm v. Eberstadt*, 72 F.R.D. 187 (N.D. Ill. 1976). Thereupon, this court, pursuant to 28 U.S.C. § 1292(b), certified the issue of whether plaintiffs' were adequate representatives of the class they sought to represent to the court of appeals, and on January 25, 1977 that court granted plaintiffs' permission to appeal. In an opinion dated August 31, 1977, the Seventh Circuit affirmed this court's ruling denying plaintiffs' motion for class certification. *Susman v. Lincoln American Corp.*, No. 77-1145 (7th Cir. August 31, 1977).[1]

Plaintiffs' have again moved for class certification stating that the reason this court found them to be inadequate

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[1] This court had certified the *Flamm* case and the *Susman* case for purposes of an interlocatory appeal since they both involved the same class action issue.

class representatives no longer exists and class certification is appropriate at this time. However, before the briefing on this question was completed and this court could rule on plaintiffs' motion, defendants, in a letter dated November 1, 1977, tendered[2] to plaintiffs the amount of money they claimed they had been individually deprived of by defendants' actions as alleged in the instant complaint. Defendants have now moved to dismiss plaintiffs' complaint on the ground of mootness arguing that there does not exist at this time a justicable, Article III of the Constitution "case or controversy" between plaintiffs and defendants. Thus, defendants argue that since plaintiffs have obtained all the relief they seek to obtain from this lawsuit it would be a waste of judicial energy, as well as a violation of the constitutional prohibition against courts rendering advisory opinions, to allow this case to continue. For this proposition defendants primarily rely on the recent decision in *Winokur v. Bell Federal Sav. & Loan Ass'n*, 560 F.2d 271 (7th Cir. 1977). After reviewing the briefs submitted by the parties, this court is compelled to grant defendants' motion because of the Seventh Circuit's ruling in *Winokur*, and accordingly this cause is dismissed.

In opposition to defendants' motion, plaintiffs present two arguments. First, plaintiffs rely on a line of cases starting with *United States v. W. T. Grant Co.*, 345 U.S. 629 (1953), which hold that the "mere voluntary cessation of allegedly illegal conduct does not moot a case." *Burbank v. Twomey*, 520 F.2d 744, 747 (7th Cir. 1975). Plaintiffs argue from this proposition that defendants, by tendering

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[2] Although the plaintiffs challenge the adequacy of defendants' tender for several reasons, this court finds the letter to plaintiffs to constitute a valid tender to end the controversy between the named plaintiffs and defendants. *See, e.g.*, Guthrie v. Curnutt, 417 F.2d 764 (10th Cir. 1969); Martindell v. Lake Shore Nat'l Bank, 15 Ill. App. 2d 217, 145 N.E. 2d 784 (1957), *rev'd on other grounds*, 15 Ill. 2d 272, 154 N.E. 2d 683 (1958).

to plaintiffs the amount of their individual claims, cannot moot this action by their own voluntary acts. This analysis, however, is incorrect. As was recognized in *Winokur*, the doctrine as enunciated in *W. T. Grant* only applies if there is the possibility that the defendant will continue in the future to infringe upon plaintiff's rights. *Winokur v. Bell Federal Sav. & Loan Ass'n*, 560 F.2d 271, 274 (7th Cir. 1977). Since plaintiffs do not seek injunctive relief in this cause, and since plaintiffs have not indicated that they fear that defendants will again injure them by way of further violations of the federal securities laws, plaintiffs' first argument based upon *W. T. Grant* and its progeny is without merit.

Plaintiffs' second argument, although more substantial in this court's view, is likewise without merit in light of *Winokur*. Plaintiffs argue that because they presently have pending a motion for class certification the mere fact that their individual claims may be moot does not render this action, as a class action, moot. Thus, plaintiffs rely on the limited exception to the mootness doctrine as applied to class actions delineated in *Gerstein v. Pugh*, 420 U.S. 103, 110-11 n.11 (1975), and as applied by this and other courts. *See, e.g., Langson v. Simon*, 74 F.R.D. 456 (N.D. Ill. 1977) (Flaum, J.); *Custom v. Trainor*, 74 F.R.D. 413 (N.D. Ill. 1977) (Marshall, J.); *Robinson v. Leahy*, 73 F.R.D. 109 (N.D. Ill. 1977) (Flaum, J.).

In *Gerstein*, the Supreme Court was faced with an action by individuals who were in police custody for pretrial detention. The plaintiffs, seeking to represent a class of all persons subject to such pretrial detention who were not afforded preliminary hearings as to the charges levied against them, challenged their confinement as violative of due process of law. The Supreme Court, in reviewing the record before it, noted that the named plaintiffs had been convicted of the charges against them and were no longer in pretrial custody. Moreover, the court noted that the

record was not clear as to whether at the time the trial court granted plaintiffs' motion for class certification the named plaintiffs were still in pretrial detention and had a viable case or controversy with the defendants. *Gerstein v. Pugh*, 420 U.S. 110-11 n.11.

In considering whether the action was moot because the named plaintiffs' claims had been resolved, the Supreme Court stated that even if there had not been a live controversy between the named plaintiffs and defendants at the time the class certification motion was granted, the plaintiffs' action could continue to vindicate the rights of those the named plaintiffs sought to represent. Thus, the court stated that although as a general rule a named plaintiff must be a member of the class he seeks to represent at the time the class is certified, and must at that time have a live controversy with the defendant, in order for a class action to continue in light of the subsequent mootness of the named plaintiff's claim, *see Sosna v. Iowa*, 419 U.S. 393 (1975), an exception to this rule existed when: (1) the nature of the plaintiff's and the class' claims were such that the plaintiff would have suffered his injury before the court could rule on his motion for class certification; (2) it was certain that a constant class of persons suffering the deprivation existed; and (3) the attorney representing the named representative has other clients with a continuing live interest in the case, *i.e.*, a public defender. *Gerstein v. Pugh*, 420 U.S. at 111 n.11.

In the case at bar, plaintiffs argue that this action falls within the ambit of the *Gerstein* exception to the mootness doctrine and this court should rule that although the named plaintiffs' claims are moot this case should continue so as to vindicate the rights of the class the named plaintiffs seek to represent. Thus, plaintiffs argue that the unilateral action of defendants in tendering to the named plaintiffs the amount of their individual claims cannot be held to moot the class allegations because defendants will

thereupon be able to prevent a class from ever having its claims vindicated.

While this court recognizes the rule as delineated in *Gerstein*, and as noted previously has applied that rule under different circumstances, this court is bound by the holding of the Seventh Circuit in *Winokur*. In *Winokur*, plaintiffs' filed a federal securities class action in which they sought injunctive and monetary relief. Plaintiffs sought to have a class certified but the district court found that plaintiffs had not established the propriety of maintaining their action on a class-wide basis. Plaintiffs' request to have the issue certified to the court of appeals pursuant to 28 U.S.C. § 1292(b) was denied and plaintiffs were barred from appealing the denial of class status since such orders are not appealable in this circuit. *See Thill Securities Corp. v. New York Stock Exchange*, 469 F.2d 14 (7th Cir. 1972). Thereafter, defendant tendered to the named plaintiffs the amount of their individual claim and changed its policies to avoid creating the same difficulties from arising again. This court[3] thereupon dismissed the action as moot stating that no case or controversy existed between the named plaintiffs and defendant in light of the fact that class certification had been denied.

The court of appeals affirmed the order of dismissal. *Winokur v. Bell Federal Savings & Loan Ass'n*, 560 F.2d 271 (7th Cir. 1977). However, more importantly for the issues before the court in the case at bar, the court of appeals also held that it lacked jurisdiction to consider whether the district court had erred in denying class certification. Thus, plaintiffs' in *Winokur* argued that had the district court certified the class they sought to represent their action would not be moot even in light of defendant's tender. The court of appeals, plaintiffs argued, was there-

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[3]This court was transferred the *Winokur* case after the denial of class certification.

fore required to consider plaintiffs' request for class certification since plaintiffs' were not allowed to appeal the denial of their class motion previously. The Seventh Circuit rejected this argument stating the rule of law applicable to the case at bar as:

> When there is no determination that an action be maintained as a class action and the controversy between the named party in his own interest and his opponent dies, court adjudication is not appropriate because there is no controversy between parties who are present or represented before the court in the action.

It is clear to this court that the facts of this case, although different in minor respects, falls squarely within the ambit of the *Winokur* holding. Thus, as in *Winokur*, plaintiffs herein have had their motion for class certification denied and in fact this denial was affirmed. Defendants have tendered the named plaintiffs the amount of their individual claims and there is presently no case or controversy between them. The fact that their is presently pending a motion for class certification does not make this case different from *Winokur* since this is exactly the same as having an appeal before the court of appeals seeking a review of a class action motion denial.

Plaintiffs argue, however, that this court should not apply the *Winokur* case to their class action claims for several reasons. First, plaintiffs argue *Winokur* involved appellate review and the case at bar is still in the district court. While this is a difference, as stated above, it is not material. When an action becomes moot it ousts the court in which it is pending of jurisdiction to consider any other matters in that case. If the court of appeals felt itself barred by Article III to consider the propriety of class certification in *Winokur*, this court is no less barred from considering plaintiffs' renewed motion for class certification.

Second, plaintiffs argue that this court should treat its renewed motion for class certification as a motion to

"reconsider" the prior denial of class certification. This, plaintiffs argue, would allow this court to make the granting of the class motion now "relate back" to the previous denial and would prevent any mooting of plaintiffs' class claims. However, this argument is simply a restatement of the plaintiffs' first argument and for the same reasons as previously mentioned must be rejected.

Finally, plaintiffs argue that *Winokur* is wrongly decided. Thus, plaintiffs argue that the rule stated in *Winokur* and previously quoted in this opinion is directly in conflict with the holding in *Gerstein* that class actions can be certified in certain cases where the named plaintiffs' claims are mooted prior to certification. However, whatever the merits of this argument, plaintiffs position must fail in this district court which is bound by the pronouncements of its court of appeals. This court recognizes that other courts, unlike the Seventh Circuit, have reviewed denials of class certifications after plaintiff's claims have been mooted, *see, e.g., Cameron v. E. M. Adams & Co.*, 547 F.2d 473 (9th Cir. 1976); *but see Napier v. Gertrude*, 542 F.2d 825 (10th Cir. 1976), *cert. denied*, 97 S.Ct. 759 (1977). Moreover, this court notes that the Seventh Circuit did not cite *Gerstein* in its opinion in *Winokur* although it did cite cases decided after that decision.[4] Nevertheless, this court cannot say that the court of appeals did not consider *Gerstein* and finds its principles inapplicable to the case at bar. It is possible that the court of appeals was of the opinion that the *Gerstein* exception did not apply in class actions to be certified under Fed. R. Civ. P. 23(b) (3) since it is not likely that defendants would repeat their illegal activity. Or perhaps the court decided that private class action attorneys did not meet the *Gerstein* require-

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[4] In fact, the court in *Winokur* cited Board of School Comm'rs v. Jacobs, 420 U.S. 128 (1975), the decision in volume 420 of the United States Supreme Court Reports which immediately follows *Gerstein*.

ment of class action counsel who had clients like the named plaintiffs interested in the vindication of the class' rights. Hence, whatever the court of appeals' reasons, *Winokur* is decided and its mandate must be obeyed.

Accordingly, this court must declare plaintiffs' action moot. The issues raised by plaintiffs concerning the problems of maintaining a class action when the defendants have the ability to moot the case must be resolved by the court of appeals in light of *Winokur*. On its facts this action is identical to *Winokur* and it must be dismissed.

It is so ordered.

/s/ JOEL M. FLAUM
United States District Judge

Dated: December 30, 1977

UNITED STATES COURT OF APPEALS, SEVENTH CIRCUIT.

Michael SUSMAN,
Plaintiff-Appellant,

v.

LINCOLN AMERICAN CORP. et al.,
Defendants-Appellees.

Ann FLAMM and Arnold FLAMM,
Plaintiffs-Appellants,

v.

Rudolph EBERSTADT, Jr. and MICRODOT, INC.,
Defendants-Appellees.

Nos. 78-1293, 78-1310.

Argued Sept. 14, 1978.

Decided Oct. 23, 1978.

As Amended Nov. 20, 1978.

Rehearing and Rehearing In Banc Denied Dec. 5, 1978.

Before FAIRCHILD, Chief Judge, and CUMMINGS and WOOD, Circuit Judges.

FAIRCHILD, Chief Judge.

This is the consolidated appeal from the dismissals of two class action complaints. The district court, relying on this court's decision in *Winokur v. Bell Federal Savings and Loan*, 560 F.2d 271 (7th Cir. 1977), dismissed both actions as moot after the defendants tendered to the named plaintiffs their full monetary damages. We limit the *Winokur* language relied on by the district court and reverse its decision in both cases. We remand for determination of the motions for class certification that were pending at the time of the dismissal. In the *Susman* case, the district

court also dismissed the plaintiff's derivative claims. We affirm that decision in part and reverse it in part.

In these cases, unlike *Winokur*, an appeal from the the denial for class certification was effected under 28 U.S.C. § 1292(b). The facts of both cases were discussed in our decision in that appeal on the issue of whether plaintiffs' counsel could fairly and adequately represent the classes sought to be certified. *Susman v. Lincoln American Corp.*, 561 F.2d 86 (7th Cir. 1977). The facts will not be repeated here. In the prior decision we affirmed the district court's denials of class certification on the grounds that the relationship between the named plaintiffs and their counsel could lead to a conflict of interest and noted

> "[P]laintiffs are free to seek different counsel and thereby dispel any possibility of a conflict of interest. In lieu of a change in counsel which might result in a certification of the class actions, plaintiffs are not barred from continuing the lawsuits on their own behalf." 561 F.2d 96.

Clearly we recognized potential further consideration of representation of the interests of class members by the named plaintiffs.

The plaintiffs in both cases sought and obtained new counsel. Renewed motions for class certification were then filed. While the renewed motions were pending the defendants tendered to the plaintiffs the amount of money they claimed to have lost as a result of the defendants' actions plus properly chargeable costs. The offers, which were made without admissions of liability by the defendants, and which were clearly made in an attempt to render the cases moot, were refused by the plaintiffs. Nevertheless, the district court held that the defendants' offers extinguished the controversies between the parties and that as a result the court no longer had jurisdiction to decide the motions for class certification. In the *Susman* case, the district court also dismissed the plaintiff 's derivative claims.

THE CLASS ACTION

The Article III requirement that the federal courts decide only issues where there is an actual case or controversy between the parties is fundamental to our judicial system. *North Carolina v. Rice*, 404 U.S. 244, 246, 92 S.Ct. 402, 30 L.Ed.2d 413 (1971). The jurisdictional ban on making any decisions in moot cases (or, for that matter, in reviewing decisions already made) arises from this constitutional requirement. *Liner v. Jafco, Inc.*, 375 U.S. 301, 306 n. 3, 84 S.Ct. 341, 11 L.Ed.2d 347 (1964); *Powell v. McCormack*, 395 U.S. 486, 496 n. 7, 89 S.Ct. 1944, 23 L.Ed.2d 491 (1969). Yet a number of cases have been decided on the merits despite assertions that the original wrong complained of had been corrected, that the original plaintiff would no longer be affected by the outcome of the lawsuit, or that other changes in the underlying factual situation rendered the case moot. *See, e. g., United States v. W. T. Grant Co.*, 345 U.S. 629, 73 S.Ct. 894, 97 L.Ed. 1503 (1953) (corporate director resigned from interlocking directorates which were subject of the complaint); *Carroll v. President and Comm'rs of Princess Anne*, 393 U.S. 175, 89 S.Ct. 347, 21 L.Ed.2d 325 (1968) (ten day injunction complained of had expired two years previously); *Southern Pacific Terminal Co. v. I.C.C.*, 219 U.S. 498, 31 S.Ct. 279, 55 L.Ed. 310 (1911) (ICC order under attack had expired by its own terms); *Sosna v. Iowa*, 419 U.S. 393, 95 S.Ct. 553, 42 L.Ed.2d 532 (1975) (plaintiff had obtained the divorce she was seeking in another state). It is not necessary in this decision to discuss the variety of exceptions to the mootness doctrine that may be available in various cases.[1] What are important, here, however, as in *Winokur* are those cases which involve class action complaints.

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[1] There is an extensive discussion of the current state of the mootness doctrine in *Geraghty v. U.S. Parole Commission*, 579 F.2d 238 (3rd Cir. 1978).

In *Winokur* we were directly concerned with the question whether the right to appellate review of a denial of class certification could survive the death of the controversy. We held it could not. Our present case is different, and does not present that question. In *Winokur*, however, we set forth several generalizations, including

> 2. When there is no determination that an action be maintained as a class action and the controversy between the named party in his own interest and his opponent dies, court adjudication is not appropriate because there is no controversy between parties who are present or represented before the court in the action. 560 F.2d 277.

This generalization literally applies to our instant case because at the critical moment there had been no determination that the action be maintained as a class action. We think, however, that our instant case differs significantly from *Winokur* and from *Board of School Comm'rs v. Jacobs*, 420 U.S. 129, 95 S.Ct. 848, 43 L.Ed.2d 74 (1975), on which we relied in *Winokur*. Here, at the critical moment, the question of maintaining the class action had been freshly raised, consistently with the suggestion of the appellate court that it could be reopened after a change in counsel.

We consider the motion for certification, while pending, as sufficiently, though provisionally, bringing the interests of class members before the court so that the apparent conflict between their interests and those of the defendant will avoid a mootness artificially created by the defendant by making the named plaintiff whole. We limit the language of generalization No. 2 in *Winokur* accordingly.[2]

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[2] It would be arguable, on the same theory, that a complaint with class action allegations sufficiently brings the interests of the class members before the court, at least where the court proceeds with reasonable promptness to reach the issue of class

(Footnote continued on the following page)

Courts have consistently recognized that unnamed class members have an interest in lawsuit even before a Rule 23 determination is made that a class action may be maintained on their behalf. Thus, potential class members are given the opportunity to support or oppose class certification or to challenge the adequacy of representation by the named plaintiff. *Knuth v. Erie-Crawford Dairy Coop. Ass'n*, 395 F.2d 420 (3rd Cir. 1968). The statute of limitations on their individual causes of action may be tolled from the date of filing of the class action complaint. *American Pipe & Construction Co. v. Utah*, 414 U.S. 538, 94 S.Ct. 756, 38 L.Ed.2d 713 (1974). They may also have a right to be informed of, or even included in, a settlement that occurs prior to class certification. *Kahan v. Rosensteil*, 424 F.2d 161, 169 (3rd Cir.), *cert. denied*, 398 U.S. 950, 90 S.Ct. 1870, 25 L.Ed.2d 290 (1970). Thus, at least in a limited sense, the interests of the unnamed class members are before the court during the pendency of a motion for class certification.

Normally, however, a class action must be certified as such in order for it to escape dismissal once the claims of the named plaintiff become moot. *Franks v. Bowman Transportation*, 424 U.S. 747, 96 S.Ct. 1251, 47 L.Ed.2d 444 (1976); *Sosna v. Iowa*, 419 U.S. 393, 402, 95 S.Ct. 553, 42 L.Ed.2d 532 (1975). But the courts have recognized that an absolute requirement would prevent some otherwise justiciable claims from ever being subject to judicial review. Thus, in *Sosna*, the Supreme Court said

> "There may be cases in which the controversy involving the named plaintiffs is such that it becomes moot as to them before the district court can reasonably be expected to rule on a certification motion. In such instances, whether the cer-

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2 *(Continued)*

action maintenance. We do not need to reach that question. See footnote 4 *infra*.

> tification can be said to 'relate back' to the filing of the complaint may depend upon the circumstances of the particular case and especially the reality of the claim that otherwise the issue would evade review." 419 U.S. 393, 402 n. 11, 95 S.Ct. at 559.

Clearly the Court had in mind situations where the nature of the complaint was such that the mere passage of time would usually make the individual plaintiff's complaint moot before a court could reasonably be expected to rule on a certification motion. And in practice that is how the "relation back" doctrine has been applied. *Gerstein v. Pugh*, 420 U.S. 103, 95 S.Ct. 854, 43 L.Ed.2d 54 (1975). We do not have such a situation here. But, just as necessity required the development of the relation back doctrine in cases where the underlying factual situation naturally changes so rapidly that the courts cannot keep up, so necessity compels a similar result here. If the class action device is to work, the courts must have a reasonable opportunity to consider and decide a motion for certification. If a tender made to the individual plaintiff while the motion for certification is pending could prevent the courts from ever reaching the class action issues, that opportunity is at the mercy of a defendant, even in cases where a class action would be most clearly appropriate.

We hold, therefore, that when a motion for class certification has been pursued with reasonable diligence and is then pending before the district court, a case does not become moot merely because of the tender to the named plaintiffs of their individual money damages. The district court has jurisdiction to consider the motion for class certification and should hear and decide that motion prior to deciding whether or not the case is mooted by the tender. This does not mean that the district court should ignore the fact that a tender has been made. The tender may raise a question, on which we now express no opinion, as to the named plaintiffs' ability to fairly and adequately rep-

resent the class.[3] But the class certification issues should be addressed by the district court prior to dismissals of the lawsuits. We express no opinion on the appropriate decisions on the issues.

We acknowledge the conflict between this decision and that of the Eighth Circuit in *Bradley v. Housing Authority of Kansas City, Missouri*, 512 F.2d 626 (8th Cir. 1975). We believe, however, that the result we have reached here is consistent with Article III, since in fact there will be no adjudication of the merits of the lawsuit unless there is first a determination that there are adversary parties and that the requirements of justiciability are present. *Geraghty v. U.S. Parole Commission*, 579 F.2d 238 (3rd Cir. 1978). Our decision in these cases is also consistent with the recent decision of the Court of Appeals for the Fifth Circuit in *Roper v. Consurve, Inc.*, 578 F.2d 1106 (5th Cir. 1978), which contained this language

> The notion that a defendant may short-circuit a class action by paying off the class representatives either with their acquiescence or, as here, against their will, deserves short shrift. Indeed, were it so easy to end class actions, few would survive. . . . By the very action of filing a class action, the class representatives assume responsibilities to members of the class. They may not terminate their duties by taking satisfaction; a cease-fire may not be pressed upon them by paying their claims. 578 F.2d 1106, 1110.[4]

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[3] See *Kuahulu v. Employers Insurance of Wausau*, 557 F.2d 1334 (9th Cir. 1977); *Roper v. Consurve*, 578 F.2d 1106 (5th Cir. 1978); *Banks v. Multi-Family Management, Inc.*, 554 F.2d 127 (4th Cir. 1977); and generally, H. Newberg, Newberg on Class Actions §§ 1085-1092.

[4] The Fifth Circuit has held that the very filing of a class action complaint places the plaintiff in a representative capacity, even if no motion for certification has been filed or even if class

(Footnote continued on the following page)

Finally, although the recent decisions of the Ninth Circuit in *Kuahulu v. Employers Insurance of Wausau*, 557 F.2d 1334 (177) and the Third Circuit in *Geraghty v. U.S. Parole Commission*, 579 F.2d 238 (1978) both involved factually distinct situations, their emphasis, like that in *Sosna*, on evaluating claims of mootness in light of the idiosyncrasies of each individual case is consistent with the approach we have used here.

THE DERIVATIVE CLAIMS

The district court dismissed the plaintiff Susman's derivative claims against Lincoln American corporate defendants and the individual defendants on the grounds that

> "Since plaintiff does not seek recession [sic] of the alleged illegal merger, once the merger took place plaintiffs lost the ability to sue derivatively. *See Voege v. Ackerman*, 364 F.Supp. 72, 74 (S.D.N.Y.1973); *Basch v. Talley Indus., Inc.*, 53 F.R.D. 9, 11-12 (S.D.N.Y.1971); *Heit v. Tenneco, Inc.*, 319 F.Supp. 884, 887-88 (D.Del.1970)."
>
> No. 73 C 1089 (N.D.Ill., Filed January 27, 1978)

The plaintiff contends that this ruling is in error since it involved the application of state rather than federal law and that even if state law is controlling, it was misapplied on the facts of the plaintiff's case. All of the parties have referred to Delaware law as the law to be applied to the extent that state law is controlling.

We do not need to address the plaintiff's assertion that federal rather than state law should apply in determining the capacity of a shareholder to bring a suit under the

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4 *(Continued)*

certification has been denied. (See cases cited in *Roper*.) Our decision today is limited to the fairly narrow situation where a motion for certification has been pursued with reasonable diligence and is pending when a tender is made.

federal securities laws on behalf of a corporation that has been merged with a defendant corporation subsequent to the filing of the complaint since it is clear that the derivative claims asserted by the plaintiff are founded solely on state law.[5] Nor do federal equitable considerations come into play, since the plaintiff did not attempt to enjoin the merger and is not now seeking rescission—in contrast to the situation we were presented with in *Ramsburg v. American Investment Co. of Ill.*, 231 F.2d 333 (7th Cir. 1956). The only question, then, is whether under Delaware law the plaintiff may maintain this derivative suit.

Delaware law is quite clear in stating that a derivative suit seeking only money damages brought on behalf of one corporation and against another cannot survive the merger of those two corporations regardless of whether the suit was filed before or after the merger took place. *Bokat v. Getty Oil Co.*, 262 A.2d 246 (Del.Sup.Ct.1970) The dismissal of the derivative suit against Lincoln American Life Insurance Company, the surviving corporation, must

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[5] Paragraph 10 of the plaintiff's amended complaint sets forth specific allegations of improper activity by the defendants. Paragraph 11 recites that "The foregoing acts of defendants constitute deceptive devices, a scheme to defraud and misstatements and omissions to state material facts in connection with the purchase and sale of securities and in connection with the solicitation of proxies *to the detriment of minority shareholders and are violative of* Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C.A. § 78j(b)), and the rules promulgated by the Securities Exchange Commission thereunder, including Rule 10B-5" (Emphasis added.) Paragraph 12, in contrast, says "The foregoing also constitute a breach *of common law to the detriment of Consumers* and its minority shareholders in that: . . . " (Emphasis added.) The contrast between these two paragraphs clearly indicates that the federal claims are brought only on behalf of the minority shareholders (whom plaintiff seeks to represent in a class action), while the common law claims are brought both on behalf of the minority shareholders, and, derivatively on behalf of Consumers National.

therefore be affirmed.

Slightly more difficult is the question of whether the derivative suit can be maintained against third parties, even if it must be dismissed as against the surviving corporation. The Lincoln American defendants urge us to adopt the "common sense" approach of *Vine v. Beneficial Finance Co.*, 374 F.2d 627 (2nd Cir. 1967) which noted the meaninglessness of a derivative action brought on behalf of a nonexistent corporation. But in *Bokat* the Delaware Supreme Court, after dismissing the derivative claim against the surviving corporation, explicitly said

> "This conclusion, however, does not mean that the claims asserted against the individual defendants, among them J. Paul Getty, have likewise been made moot. Such is not the case." 262 A.2d at 250.

Although this statement in *Bokat* was dictum (the individual claims were barred by the statute of limitations) it was made by the Delaware Supreme Court in a case subsequent to, and indeed citing the *Vine* case relied on by Lincoln American. It must, therefore, carry more weight in this case where we must apply Delaware law.

The cited language in *Bokat* has been analyzed at some length in a decision of the United States District Court for the Southern District of New York. *Abrams v. Occidental Petroleum Corp.*, 20 Fed. Rules Serv.2d 170 (S.D.N.Y.1975) (interpreting California and Delaware law). Judge Palmieri concluded that the *Bokat* language was an attempt to reconcile the savings clause of 8 Del.Code § 261 with the anomalous situation of a corporation suing itself. Therefore, he reasoned, a derivative suit begun by a shareholder against third parties prior to a merger could be continued after the merger (because of § 261) but that a similar suit brought against what was to become the surviving corporation must be dismissed after the merger to prevent the incongruous situation of a corporation suing itself. 20 Fed.Rules Serv.2d at 175.

We cannot disregard the clear language of the Delaware Supreme Court. We hold, therefore, that while the dismissal of the derivative claims against Lincoln American Life Insurance Company must be affirmed, the dismissal of those same claims against the third-party defendants must be reversed.

Insofar as the judgments appealed from dismissed the actions as moot without considering the questions of certification, and insofar as the judgment in No. 78-1293 dismissed the derivative action against parties other than Lincoln American Life Insurance Company, they are reversed and the causes remanded for further proceedings consistent with this opinion. In all other respects they are affirmed.

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

ANN FLAMM and ARNOLD M. FLAMM, *Plaintiffs,* *v.* **RUDOLPH EBERSTADT, JR. and MICRODOT, INC.,** *Defendants.*	76 C 427

MEMORANDUM OPINION

JOEL M. FLAUM, District Judge:

This matter comes before the court on plaintiffs' renewed motion for plaintiff class certification pursuant to Fed. R. Civ. P. 23(c). For the reasons stated below, the motion is granted.

The motion has been before the court once before. Class certification was denied because the relationship between plaintiffs and their counsel might have led to a conflict of interest contrary to the dictates of Fed. R. Civ. P. 23(a)(4). This ruling was affirmed. *Susman v. Lincoln Am. Corp.*, 561 F.2d 86 (7th Cir. 1977) (*Susman I*). After retaining new counsel, plaintiffs' renewed their motion. While the matter was pending, defendants tendered to plaintiffs the amount of money they individually claimed. Because of that tender and on defendants' motion to dismiss, the court ruled that the case between the named parties was moot and the action was dismissed. This decision was reversed, *Susman v. Lincoln Am. Corp.*, 587 F.2d 866 (7th Cir. 1978), *cert. denied*, 445 U.S. 942 (1980) (*Susman II*), so the class certification issue is again ready for disposition.

The complaint generally alleges that defendants made material false misstatements or omissions in connection

with the sale of Microdot, Inc. common stock during the pendency of a tender offer by General Cable Corp., in violation of sections 10(b) and 14(e) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(b) and n(e). The named plaintiffs are co-trustees of a trust which purchased and sold shares of Microdot stock in the relevant period. They seek to represent a class composed of:

> All sellers of common stock of Microdot, Inc. during the period beginning on December 5, 1975 and ending at the close of business on January 23, 1976, excluding the defendants and those in concert with them.

Plaintiffs complain that defendants issued a series of misstatements or omissions which: stated falsely an ideological opposition to all tender offers; omitted the fact that simultaneous to the General Cable tender offer and defendants' opposition to it, defendants were seeking a friendly takeover offer; and failed to disclose Microdot's cash and short-term investments, which made Microdot's financial position more favorable than previous statements had indicated. Four exhibits form the basis of the complaint. Exhibit A is a letter and press release from defendant Eberstadt (President of Microdot) to Microdot shareholders. In the letter, Eberstadt informs the reader, *inter alia*, that the board of directors unanimously recommended a rejection of the General Cable offer. The press release indicates Microdot would employ all its resources to defeat the offer. Exhibit B is another letter from Eberstadt to shareholders. In that communication, the defendant expressed his negative views on the number of takeover offers of medium size American companies like Microdot.[1] Eberstadt also

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[1] Eberstadt's views were communicated in the letter dated December 11, 1975 (Exhibit B), where he stated (in part):

> If no successful growth company of medium size is able to resist the raids of large outsiders, there will be no way for

(Footnote continued on the following page)

suggested that the prime motive for General Cable's tender offer was the personal enrichment of General Cable's president. Exhibits C and D are two more letters from Eberstadt in which he continued to counsel shareholders against acceptance of General Cable's offer.

Defendants oppose certification of the class on three grounds. First, defendants contend plaintiffs cannot meet the commonality and predominance requirements of Fed. R. Civ. P. 23(a)(2) and (b)(3). They argue that in a case where several statements are relied on as the basis of the cause of action, there must be a material misrepresentation common to all the documents. Here, defendants submit that none of the documents contains the alleged aversion to all takeovers. They maintain that Eberstadt only expressed a stand against surprise, non-negotiated tender offers. Further, defendants contend that the alleged ideological aversion only appears in one document and is not a common thread through all the exhibits as required by *Gelman v. Westinghouse Elec. Corp.*, 73 F.R.D. 60 (W.D. Pa. 1976), *aff'd*, 612 F.2d 799 (3d Cir. 1980), and *Feldman v. Lipton*, 64 F.R.D. 539 (S.D.N.Y. 1974). Because of the sep-

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1 *(Continued)*

> American stockholders to realize the potential these growth companies represent. Then there will be no future IBM, no Xerox, no Polaroid. They will be choked off and smothered as soon as they start to show their real growth potential.

In the letter of January 5, 1976, (Exhibit D), Eberstadt said (in part):

> [Y]ou may have seen an advertisement reprinting a letter I wrote on December 12 to Chief Executive Officers of 524 American companies with sales between $100 million and $400 million urging them to oppose surprise, unnegotiated tender offers of the kind undertaken by General Cable. The response to that letter has been very encouraging. I'm enclosing a brochure which sets forth some of the responses I have received.

arate contents of each document, defendants argue unique issues of fact and law concerning reliance and materiality will predominate over any common issues.

Defendants' second argument opposing certification is based on the relationship of plaintiffs' claim to those of the putative class members. Defendants argue that the typicality and adequate representation requirements of Rule 23 (a)(3) and (4) necessitate a co-extensive interest among all members of the class. Co-extensiveness, defendants submit, requires a common objective and factual positions that are not inconsistent. Defendants contend that this class would contain members with inconsistent factual positions because it would include all sellers of Microdot stock even though they purchased after some of the alleged misstatements were made. Thus, defendants argue some of the putative class members made an investment decision both to purchase and to sell Microdot shares based upon the same alleged misstatements, while the other members only sold shares during the class period. This situation, defendants maintain, presents inconsistencies that are not permitted under Rule 23(a)(3) and (4).

Defendants final argument also relates to the issue of adequate representation in subsection (a)(4). Defendants urge that the substitution of counsel for the named plaintiffs has not completely eliminated the spector of conflict identified in *Susman I*. Defendants note that the new attorney's affidavit filed pursuant to Local Rule 39 does not expressly state that Mr. Susman and Mr. Meites do not have a continuing interest in any eventual attorney's fees. Therefore, defendants argue that there is no factual basis on which to conclude the Flamm plaintiffs no longer have an interest in the fees. Without that affirmative conclusion, defendants submit that the Flamms cannot be adequate representatives.

In determining whether a class should be certified in a securities case, Rule 23 must be liberally construed in

deference to a strong policy favoring class actions. *King v. Kansas City Southern Indus., Inc.*, 519 F.2d 20 (7th Cir. 1975); *Hochschuler v. G. D. Searle & Co.*, 82 F.R.D. 339 (N.D. Ill. 1978); *Helfand v. Cenco, Inc.*, 80 F.R.D. 1 (N.D. Ill. 1977). This liberal policy recognizes that private class actions can effectively deter corporate wrongdoing and encourage mandated disclosures. *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976); *Green v. Wolf Corp.*, 406 F.2d. 291 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969) Additionally, of course, the class action provides a useful tool for individuals with small claims who would otherwise be unable to bear the costs of litigation. *Hochschuler v. G. D. Searle & Co.*, 82 F.R.D. 339 (N.D. Ill. 1978); *Helfand v. Cenco, Inc.*, 80 F.R.D. 1 (N.D. Ill. 1977).

Notwithstanding these general principles, plaintiffs still bear the burden of demonstrating compliance with the requirements of Rule 23. *Hochschuler v. G. D. Searle & Co.*, 82 F.R.D. 339 (N.D. Ill. 1978). Plaintiffs must first meet all the prerequisites of Rule 23 (a) and then demonstrate the propriety of a (b)(3) class. Throughout this consideration, no inquiry into the merits of the suit is permitted. *Eisen v. Carlisle & Jacqueline*, 417 U.S. 156, 177-78 (1974).

At the time of briefing, the incomplete state of discovery did not permit a determination of the exact number of sellers of Microdot stock from December 5, 1975 to January 23, 1976. However, plaintiffs estimate there are thousands of sellers because Microdot had 3.6 million shares outstanding. Defendants assume without conceding that plaintiffs can in fact establish a sufficient number of similarly situated sellers making joinder impracticable. Therefore, the numerosity requirement of Rule 23 (a)(1) is considered met.

Under subsection (a)(2) of the Rule, plaintiffs must demonstrate that questions of law or fact are common to all members of the class. Plaintiffs have alleged that defen-

dants engaged in a common course of conduct and they argue the case comes within a line of cases recognizing that a common course of conduct presents common issues under (a)(2). *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976); *Green v. Wolf Corp.*, 406 F.2d 291 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969); *Hochschuler v. G. D. Searle & Co.*, 82 F.R.D. 339 (N.D. Ill. 1978). Defendants chose to argue this issue in conjunction with the predominance requirement of subsection (b)(3). Because the Rule specifically distinguishes separate requirements, the court will analyze them individually.

One of the cases on which defendants primarily rely did address the (a)(2) requirement separately. In *Feldman v. Lifton*, 64 F.R.D. 539 (S.D.N.Y. 1974), plaintiffs attempted to certify a class of purchasers over a ten-year period. Plaintiffs argued that their complaint alleged a course of conduct, including many fraudulent statements, designed to manipulate the market price of the stock and that therefore the commonality requirement was met. The court first reasoned that the plaintiffs must provide detailed proof of the specific fraudulent statements that constituted the common course of conduct. Otherwise, the court would be unable to determine whether a common thread of misrepresentations existed. Because the plaintiffs had provided only general allegations, the court concluded plaintiffs had failed in their burden of demonstrating common issues and the class was not certified.

This case is easily distinguished from *Feldman*. Plaintiffs have attached the documents on which they rely and the relevant class period is less than two months. Yet defendants contend that there is no common thread to the series of statements because none express an ideological opposition to tender offers. They characterize the statements as only opposing surprise, non-negotiated tender offers. However, such argument goes more to the merits of the issue of whether what was said was a misrepre-

sentation. That type of inquiry is inappropriate on this motion. In addition, opposition to the General Cable offer and the reasons therefor clearly form a common thread. Furthermore, plaintiffs' theory is also based on the nondisclosure of defendants' financial position and negotiations for a friendly takeover throughout the period of General Cable's offer. Clearly, the general issue of whether the public statements contain material misrepresentations or omissions is common to the class. This is all that is required of subsection (a)(2), even as interpreted in defendants' other principal case, *Gelman v. Westhinghouse Elec. Corp.*, 73 F.R.D. 60, 66 (W.D. Pa. 1976), *aff'd*, 612 F.2d 799 (3d Cir. 1980).

The typicality requirement of subsection (a)(3) is partially subsumed in the tests of adequate representation mandated by (a)(4). *Helfand v. Cenco, Inc.*, 80 F.R.D. 1, 6 (N.D. Ill. 1977). Defendants have also argued these two subsections in conjunction, claiming that the factual positions of class members would be inconsistent because of the different times at which they purchased Microdot stock. However, this court has previously used a separate two-part test for typicality which will be followed here. Under subsection (a)(3), the interest of the plaintiffs and the class cannot be antagonistic and there must be a common nucleus of operative fact underlying plaintiffs' claims and those of the class. *Hochschuler v. G. S. Searle & Co.*, 82 F.R.D. 339, 344 (N.D. Ill. 1978). In this case, a common nucleus of fact would clearly underlie all claims. Furthermore, even if some members of the class are considered to be in inconsistent positions, their interests would not be antagonistic. All members would attempt to prove each of defendant's statements to be material misrepresentations regardless of the date of purchase. Although later purchasers may present different reliance questions, the named plaintiffs' claims are not atypical of the class'.

The final prerequisite of adequate representation in

subsection (a)(4) triggers several issues here. Two are raised by defendants and one by the Seventh Circuit in *Susman II*. Defendants' first argument, referred to above, is that the plaintiffs' and class' claims would be based on inconsistent factual premises and therefore would not be coextensive. The purpose of requiring that the class representative's and the class' interests coincide (or that they be coextensive) is to ensurse that the named plaintiff will be sufficiently motivated to prove the claims of the class. Defendants' argument, that some class members' claims would be inconsistent because some purchased and sold relying on the same alleged misstatements and omissions, does not undermine plaintiffs' motivation to prove the class' claims that shares were sold in reliance upon material misrepresentations. The purported inconsistency might raise individual issues of reliance, but it does not render the Flamms inadequate representatives of the class.

Defendants' second argument under (a)(4) addresses the other component of the adequate representation requirement, the qualifications of counsel, which was the subject of *Susman I*. After concluding that the then counsel would be inappropriate, the Seventh Circuit stated the plaintiffs were "free to seek different counsel *and thereby dispel any possibility of a conflict of interest.*" 561 F.2d 86, 96 (7th Cir. 1977) (emphasis added). Defendants now contend that the mere substitution of counsel does not completely eliminate the specter of conflict because the current and prior counsel have not sufficiently disclosed the circumstances of their relationship. The court is not persuaded by this contention. The Seventh Circuit's language does not require any such affirmative demonstration or disclosure. In the absence of any other evidence that the relationship of current counsel and plaintiffs could lead to conflicts of interest, there is no basis for concluding that the class will not be adequately represented.

The final issue under Subsection (a)(4) was raised by

the Seventh Circuit in *Susman II*, but not addressed by either party on remand in this court. The Court of Appeals held that the defendants' tender of the amount claimed by the Flamms did not render the plaintiffs' claims moot, but it indicated the tender shifts the focus of inquiry to whether plaintiffs are adequate representatives. 587 F.2d 866, 870 (7th Cir. 1978), *cert. denied*, 445 U.S. 942 (1980). *See also United States Parole Com'n v. Geraghty*, 445 U.S. 388, 405-07 (1980), quoting *Sosna v. Iowa*, 419 U.S. 393, 403 (1975). In *Sosna*, the class representative's individual claim was moot, but the Court concluded she was an adequate representative because there were no conflicting interests and the interests of the class had been competently urged throughout the litigation. These same reasons plus the additional factor that plaintiffs have refused defendants' tender lead the court to conclude that on the basis of the existing record the Flamms are adequate representatives.

Because plaintiffs have met all the prerequisites of Rule 23(a), the only remaining issue is whether the common issues of law or fact predominate over any questions affecting individual members of the class.[2] Most of defendants' argument on the predominance question was devoted to the contention that no common thread permeates the series of public statements. Since the court has rejected that assertion, defendants' only argument is that the several statements create individual questions of materiality and reliance that will predominate as they did in *Gelman v. Westinghouse Elec. Corp.*, 73 F.R.D. 60 (W.D. Pa. 1976), *aff'd*, 612 F.2d 799 (3d Cir. 1980). However, this same contention was presented and rejected in *Hochschuler v. G. D. Searle & Co.*, 82 F.R.D. 339, 349 (N.D. Ill. 1978)

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[2] Defendants have not argued that the class action is not superior to other available methods for the fair and efficient adjudication of the controversy. It clearly is if all other requirements are met.

and for the same reasons the argument is not controlling here.

In *Hochschuler*, the plaintiff's claim was based on a common course of conduct concealing information. In opposing class certification, the defendants argued that the alleged misrepresentations were accurate so that individual questions of plaintiffs' misconceptions were raised. Defendants also contended that individual issues of materiality, scienter, reliance and damages would predominate. However, this court concluded that "[w]here a common nucleus of fraud within several representations or omissions is alleged, the predominance question has been met." 82 F.R.D. 339, 349 (N.D. Ill. 1978). The court also found *Gelman* distinguishable as it does here: in *Gelman* the "plaintiff's claims were based not on a single or substantially constant misdeed, but rather on a changing fluctuating series of alleged events." 82 F.R.D. at 349 (citation omitted). For these reasons, plaintiffs' claims meet the predominance requirement of subsection (b)(3).[3]

Accordingly, this case shall be maintained as a class action on behalf of all sellers of common stock of Microdot, Inc. during the period beginning on December 5, 1975 and ending at the close of business on January 23, 1976, excluding the defendants and those in concert with them.

It is so ordered.

/s/ JOEL M. FLAUM
UNITED STATES DISTRICT JUDGE

DATED: July 22, 1981

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[3] Of course, under subsection (c)(1) of Rule 23, this class determination order may be altered or amended, if necessary, before a decision on the merits. Additionally, subsection (a)(4) permits division into subclasses if appropriate.

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

ANN FLAMM and ARNOLD M. FLAMM, *Plaintiffs,* *v.* **RUDOLPH EBERSTADT, JR., and MICRODOT, INC.,** *Defendants.*	76 C 427

MEMORANDUM OPINION

JOEL M. FLAUM, District Judge:

This matter is before the court on defendants' motion to reconsider the court's order dated July 22, 1981, which granted plaintiffs' motion for class certification. For the reasons stated below, the motion to reconsider is denied.

The facts underlying this case are reported in several other opinions[1] and will not be repeated here. On this motion, defendants primarily contend that the named plaintiffs, Ann Flamm and Arnold M. Flamm, cannot fairly and adequately represent the class so the class should not have been certified.[2] The defendants first argue that plain-

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[1] Susman v. Lincoln Am. Corp., 587 F.2d 866 (7th Cir. 1978), *cert. denied*, 445 U.S. 942 (1980) ("*Susman II*"); Susman v. Lincoln Am. Corp., 561 F.2d 86 (7th Cir. 1977) ("*Susman I*"); Flamm v. Eberstadt, No. 76 C 427, (N.D. Ill. July 22, 1981 and Dec. 30, 1977); Flamm v. Eberstadt, 72 F.R.D. 187 (N.D. Ill. 1976).

[2] Defendants also argue alternatively that if class certification is appropriate, the current class definition is too broad. However, as was indicated in the July 22, 1981 opinion, the class definition may be altered or amended, if necessary, before a decision on the merits.

tiffs have no standing to be class representatives because they no longer have individual causes of action. Defendants also submit that plaintiffs failed to prosecute this case for one and one-half years and, thus, apparently will not vigorously represent the class. Finally, defendants maintain that plaintiffs' status as trustees of the Irving H. Flamm trust ("Flamm trust") creates an impermissible conflict with their duties as class representatives and that in pursuing this lawsuit, plaintiffs have violated their fiduciary duties as trustees. The impermissable conflict is said to exist because plaintiffs as class representatives must diligently prosecute this case, while plaintiffs as trustees must protect the trust funds and avoid unnecessary expenses. Defendants also allege that Arnold M. Flamm violated his fiduciary duty as trustee when he and Ann Flamm initially retained a law firm in which Arnold M. Flamm had an interest and would thereby personally profit from fees the law firm might have recovered. Additionally, defendants allege that the plaintiffs have breached their duties as trustees by pursuing this case as a class action, which will require costs far beyond their possible individual recovery.

In response to this motion, plaintiffs argue that defendants have brought no new circumstances to the court's attention and that defendants are submitting arguments that have been rejected by this court and the Court of Appeals. Specifically, plaintiffs argue that defendants' standing argument is just a "verbal twist" of the mootness issue resolved by the Seventh Circuit in *Susman II*. In addition, plaintiffs maintain that they have a personal stake in the outcome of the litigation because they have refused defendants' tender and they are bearing the costs of the litigation. Further, plaintiffs argue they have diligently pursued this lawsuit which has been to the Sev-

enth Circuit twice.[3] Finally, plaintiffs contend that their status as trustees does not disqualify them as class representatives because their responsibilities as trustees and class representatives do not conflict and because Arnold M. Flamm is personally bearing the costs of the litigation so that no trust funds are being used.

In regard to the issue of whether plaintiffs have failed to prosecute this matter diligently, the court cannot find that plaintiffs have been dilatory to the detriment of the class. After defendants' petition for certiorari was denied in *Susman II*, the case was remanded to this court for renewed consideration of class certification. Because plaintiffs are not responsible for any delay, they are not inadequate representatives for lack of diligence. The court also finds unpersuasive defendant's argument that plaintiffs have conflicting duties as class representatives and as trustees of the Flamm trust. The plaintiffs' status as trustees does not of itself disqualify them as representatives of the class. *See Hochschuler v. G. D. Searle & Co.*, 82 F.R.D. 339, 346 n.11 (N.D. Ill. 1978); *Seiden v. Nicholson*, 69 F.R.D. 681, 689 (N.D. Ill. 1976). Further, the court cannot find that the plaintiffs' first choice of counsel in this case constitutes a breach of fiduciary duty to the Flamm trust. Although the retention of that law firm created impermissable conflicts of interest for class certification with these plaintiffs as representatives, the issue was a developing one and had not been definitively resolved in this circuit.[4] Finally, plaintiffs have answered defendants' contention regarding the expenditure of trust funds

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[3] In *Susman II*, defendants also petitioned the Supreme Court for a writ of certiorari, but the petition was denied. 445 U.S. 942 (1980).

[4] Additionally, in *Susman I*, the Seventh Circuit noted that its decision was not intended as an adverse reflection, either professionally or personally, upon the counsel involved. 561 F.2d at 96.

by revealing that no trust funds have been or will be used in this litigation. Therefore, plaintiffs' status and conduct as trustees of the Flamm trust do not render them inadequate representatives.

Defendants' standing argument raises more difficult issues. This court previously concluded, relying on *Sosna v. Iowa*, 419 U.S. 393 (1975), that plaintiffs were adequate representatives because the existing record indicated that the interests of the class had been competently urged, the plaintiffs had refused defendants' tender of damages, and there were no conflicting interests between plaintiffs and the class. Defendants' ask the court to reconsider this conclusion for two reasons. First, they argue that *Sosna* should not have been relied on because in that case the class representative's individual claim became moot after the class had been certified, while in this case, the tender to plaintiffs occurred before class certification. Second, defendants argue that plaintiffs' individual claims are not only moot, but plaintiffs also no longer have any personal stake in the matter because Arnold M. Flamm is personally bearing the costs of the litigation. In responding to these issues, plaintiffs argue that Supreme Court decisions issued since *Sosna* have established that the timing of class certification is not determinative of the issue. Specifically, plaintiffs point to the following language of *United States Parole Com'n v. Geraghty*, 445 U.S. 388, 398 (1980): "Although one might argue that *Sosna* contains at least an implication that the critical factor for Art. III purposes is the timing of class certification, other cases, applying a 'relation back' approach, clearly demonstrate that timing is not crucial." Plaintiffs also note that this relation back theory was relied on by the Seventh Circuit in this case in *Susman II*.

The references to the timing of the certification of a class in *Geraghty* and *Susman II* are not necessarily controlling here because the issue addressed in those cases is whether an Article III case or controversy exists, not whether a named plaintiff whose claim has been satisifed can be an adequate representative. Thus, although the teachings of *Geraghty* and *Susman II* are certainly relevant here, this court must also consider earlier case law in determining the adequacy of plaintiffs as class representatives. Defendants cite cases which hold that a plaintiff with no standing to raise the claim in the complaint cannot be an adequate class representative. Those decisions, however, were made in different factual contexts. In *Lavin v. Chicago Bd. of Educ.*, 73 F.R.D. 438 (N.D. Ill. 1977), a plaintiff who suffered no continuing injury and whose interest in the action was only monetary sought to represent a class seeking injunctive relief. The complaint sought relief in regard to certain high school regulations and at the time of the court's opinion, the plaintiff was no longer a high school student. The court determined that the plaintiff was an inadequate representative because the plaintiff's individual interests were not coextensive with the class' and they created a potential conflict. In this case, there is no conflict in terms of injunctive and monetary relief sought and the circumstances that changed the plaintiffs' position are quite different. Here, the defendants caused plaintiffs' claims to become moot; it was not the passage of time that placed plaintiffs in a different posture. *Johnson v. Teasdale*, 456 F. Supp. 1083 (W.D. Mo. 1978), is also distinguishable. In that case, the pro se complaint contained no allegations of personal injury or infringement of rights. Thus, the court concluded that the plaintiff had no standing to bring his individual claim and, therefore, he could not seek relief on behalf of a class. In this case, on the other hand, plaintiffs clearly had standing to bring this action on the basis of the allegations in the complaint. Their claims were extinguished only because of defendants' tender. Finally, in *Wofford v. Safeway Stores*,

Inc., 78 F.R.D. 460 (N.D. Calif. 1978), a proposed class representative in an employment discrimination suit who had judgment entered against him was rejected as a class representative because he was no longer a member of the putative class. However, in the present case, there has not been a judgment entered against plaintiffs and even if there had been a judgment entered, it would have been based on defendants' offer to make plaintiffs whole, not on a finding of no liability to the plaintiffs.[5]

The court finds the situation presented by this case sufficiently distinguishable from the above cases such that a defendant's tender of full damages to a proposed class representative does not alone render that plaintiff an inadequate representative. Ordinarily, a named plaintiff will retain a personal stake in a class action case even if the defendant has satisfied that plaintiff's individual claim. *See Deposit Guaranty Nat'l Bank v. Roper*, 445 U.S. 326, 336-37 (1980). That personal stake is the potential to shift part of the cost of the litigation to other members of the putative class who will benefit if the class prevails. Thus, "a mootness artificially created by the defendant by making the named plaintiff whole", *Susman II*, 587 F.2d 866, 869 (7th Cir. 1978), does not extinguish the named plaintiff's interest in the action. In addition, but for the defendant's tender of full damages, the plaintiff's claims and interests would be the same as the remaining members of the putative class. Defendants should not be permitted to "pick off" proposed class representatives before the propriety of certification is resolved and thereby frustrate a class action otherwise appropriate, just as defendants should not be able to render a proposed class action moot by tendering

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[5] Defendants have relied on one other case, Britt v. McKenney, 529 F.2d 44 (1st Cir.), *cert. denied*, 429 U.S. 854 (1976), but the court deems it of questionable precedential value in light of Gerstein v. Pugh, 420 U.S. 103 (1975), and subsequent Supreme Court decisions discussed in this opinion.

full damages to the named plaintiff before the issue of certification is determined. *See Deposit Guaranty Nat'l Bank v. Roper*, 445 U.S. 326, 339 (1980); *Susman II*, 587 F.2d 866, 870-71 (7th Cir. 1978), *quoting Roper v. Consurve, Inc.*, 578 F.2d 1106, 1110 (5th Cir. 1978). Therefore, the court concludes that a defendant's tender of damages to a proposed class representative before a motion for class certification is decided does not alone render that proposed class representative inadequate and the court's previous reliance on *Sosna v. Iowa*, 419 U.S. 393 (1975), was not inappropriate.

Defendants' second argument that plaintiffs are not adequate class representatives because of their lack of interest in this matter presents an issue not considered by the court before. In the round of briefs filed on this motion, plaintiffs revealed for the first time that they, as trustees, are not providing the funds to pursue this litigation.[6] Rather, Arnold M. Flamm is bearing those costs personally. Defendants argue that it is, thus, only Arnold M. Flamm who individually has a continuing personal stake in this litigation. Proceeding with that line of thought, defendants contend that since Arnold M. Flamm individually has not suffered the injury alleged in the amended complaint, he cannot be a member of the class nor can he represent it because his interests are not coextensive with the class'. In addition, defendants maintain that because the named plaintiffs have not incurred any costs or expenses and because they have been tendered their individually claimed damages, they no longer have any inter-

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[6] Plaintiffs have argued that a class should not be decertified unless it is clear changed circumstances make continued class action treatment improper. The personal assumption of costs by Arnold M. Flamm has been a fact in existence since 1976. It was not brought to the court's or defendants' attention previously, however.

est in the case and cannot represent the class.[7] Plaintiffs have not responded to these arguments because they were first made in defendants' final reply memorandum. However, it is clear from the plaintiffs' exhibit to their memorandum in response to this motion that the plaintiffs as trustees are not incurring any expenses in this lawsuit.

Adequate representation is a crucial due process requirement in any class action. *See In re General Motors Corp. Engine Interchange Lit.*, 594 F.2d 1106 (7th Cir.), *cert. denied*, 444 U.S. 870 (1979); *Helfand v. Cenco, Inc.*, 80 F.R.D. 1 (N.D. Ill. 1977). Thus, the court has a continuing duty to stringently examine the adequacy of representation by the named representatives. *Id.* As set forth in the July 22, 1981 opinion, one requirement of adequate representation is that a class representative's interests must be coextensive with the class' interests to ensure that the representative is sufficiently motivated to prove the claims of the class. In this case, the plaintiffs' interests are no longer precisely the same as other members of the class because the defendants have tendered to plaintiffs their individual damages. As discussed above though, such a tender and the concomitant mootness of plaintiffs' indi-

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[7] Defendants have also raised the issue of the propriety of a third party providing the funds to pursue a lawsuit. Two courts that have addressed the issue of a third party volunteering to pay the costs of litigation similar to this have taken different positions on the matter. *Compare* Norman v. Arcs Equities Corp., 72 F.R.D. 502 (S.D.N.Y. 1976) (individual offers to pay costs for plaintiff trust fund) *with* Kane Assoc. v. Clifford, 80 F.R.D. (E.D.N.Y. 1978) (trustee personally provides funds for suit in name of trustee). The *Norman* court reasoned that such an arrangement "smacks of Maintenance", 72 F.R.D. at 504, while the *Kane Assoc.* court reasoned that a trustee's personal assumption of costs created no conflict or impropriety because of the trustee's right and obligation to pursue his beneficiaries' claims. 80 F.R.D. at 410. In the circumstances of the present case, this court deems it appropriate to follow the reasoning of *Kane Assoc.*

vidual claims does not alone render them inadequate representatives because plaintiffs in that position ordinarily have a continuing personal stake in the action to ensure adequate representation of the class and because if the tender automatically rendered plaintiffs inadequate, defendants would be able to prevent unilaterally the maintenance of an otherwise appropriate class action. In addition, even though plaintiffs do not have a personal financial stake in the form of potential distribution of costs among class members because they have not incurred, nor will they incur, any expenses in this litigation, the plaintiffs have clearly demonstrated a sufficient motivation to prove the claims of the class throughout the protracted history of this case. Therefore, the court accepts the plaintiffs as adequate representatives of the class.

Accordingly, defendants' motion to reconsider the memorandum opinion and order dated July 22, 1981 is denied.

/s/ JOEL M. FLAUM
UNITED STATES DISTRICT JUDGE

DATED: March 5, 1982

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

ANN FLAMM and ARNOLD M. FLAMM,
Plaintiffs,

v.

RUDOLPH EBERSTADT, JR. and MICRODOT, INC.,
Defendants.

76 C 427

MEMORANDUM OPINION

JOEL M. FLAUM, District Judge:

This matter is before the court on plaintiffs' motion for leave to file the appearances of certain attorneys as additional counsel for plaintiffs and the class. Specifically, plaintiffs seek leave of court to file the appearances of Thomas R. Meites, Lee H. Weiner and Lynn Sara Frackman of the law firm of Meites & Frackman. Mr. Meites has already appeared on behalf of the plaintiffs as co-counsel in the early stages of this action. However, he and his co-counsel withdrew their appearances in favor of substitute counsel after the court of appeals affirmed this court's decision that plaintiffs could not be adequate representatives of the class if they were represented by their original counsel. Plaintiffs now seek permission for Mr. Meites, along with two of his associates, to again represent plaintiffs and the class because they contend Mr. Meites' familiarity with and work on the issues and facts of this case will aid the class and because the circumstances which were the basis of the earlier rulings on adequacy of representation have changed such that plaintiffs can be adequate representatives of the class when represented by Mr. Meites and his associates.

Having reviewed the plaintiff's motion, affidavit and exhibit and the defendants' opposition to said motion, the

court finds that in the intervening years from the court of appeals decision to the present motion, the circumstances of Mr. Meites' association with the law firm of Prins, Flamm and Susman, Ltd. have significantly changed such that the potential conflict of interest and appearance of impropriety is no longer present. Accordingly, plaintiffs' motion for leave to file the appearances of certain attorneys is granted.

/s/ JOEL M. FLAUM
UNITED STATES DISTRICT JUDGE

DATED: September 8, 1982

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

ANN FLAMM and ARNOLD M. FLAMM,
Plaintiffs,

v.

RUDOLPH EBERSTADT, JR. and MICRODOT, INC.,
Defendants.

76 C 427

MEMORANDUM OPINION

JOEL M. FLAUM, District Judge:

This matter is before the court on defendants' motion to dismiss the complaint in its entirety or, alternatively, in part. For the reasons stated below, the motion is granted in part and denied in part.

This action arises out of a tender offer contest for the stock of Microdot, Inc. ("Microdot"). The amended complaint ("complaint") alleges violations of: § 14(e) of the Williams Act, 15 U.S.C. § 78n(e) ("§ 14(e)"); § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) ("§ 10(b)"); SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 ("Rule 10b-5"); and certain state and common law fiduciary obligations. A class has been certified. As alleged in the complaint the facts of this case are as follows:

Plaintiffs owned 200 shares of Microdot common stock from about March 30, 1971 to December 29, 1975. After the close of trading on December 2, 1975, General Cable Corporation ("General") announced through press releases and other means its intention to make an offer to purchase all outstanding share of Microdot common stock at a price of $17.00 per share. As a result of this announcement by General, the price of Microdot's common stock in the public exchange went up from $11.75 per share to

$17.00 per share when trading resumed on December 5, 1975. Microdot's management immediately launched a vigorous campaign in opposition to General's proposed tender offer. On December 5, 1975, Microdot announced in a news release that its Board of Directors had voted unanimously to recommend rejection of General's proposed offer. The news release indicated that Microdot intended to employ all of its available resources to defeat the offer. In addition, Microdot's president, Rudolph Eberstadt, Jr. ("Eberstadt"), issued a letter to Microdot's shareholders announcing that he and Microdot's management were opposed to takeover raids of medium size companies by large unrelated corporations because such takeovers stifle growth in the American economy. Despite this statement concerning Microdot's and Eberstadt's opposition to tender offers, Microdot was secretly negotiating for a friendly tender offer at a price substantially higher than the market price. These negotiations culminated in an announcement on January 26, 1976 by Northwest Industries ("Northwest") that it planned to make a tender offer for all of Microdot's outstanding shares for $21.00 per share. Microdot's officers and directors had previously secretly consented to recommend acceptance of that offer, which was formally made on January 28, 1976. Plaintiffs and members of the class, misled by Microdot's repeated statements opposing tender offers and deprived of the crucial information about Microdot's real intentions of soliciting a white knight takeover, sold their shares of Microdot common stock on the open market between December 5, 1975 and January 23, 1976.

Defendant's motion to dismiss is based primarily on *Panter v. Marshall Field & Co.* ("*Panter*"), 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981). Defendants first argue that the gist of the complaint is that defendants' allegedly wrongful acts caused plaintiffs to miss an opportunity to tender their shares at a higher price than the price for which they sold them. Defendants then contend that these claims of a lost tender opportunity fail to

state a violation of the federal securities laws under *Panter* because no tender offer was pending at the time of plaintiffs' sale of their shares in the open market. This assertion is based on the facts that the General tender offer was never made to Microdot shareholders and that Northwest's tender offer was not made until January 28, 1976. Defendants also argue that certain nondisclosures alleged in the complaint are not actionable. Specifically, defendants submit that they were not obligated to disclose their actual reasons for opposing General's proposed tender offer. Further, defendants maintain that they were not required to disclose their solicitations of a friendly tender offer.

In *Panter*, the court considered a situation in which a proposed exchange offer was announced whereby a combination of stock and cash was offered for each share tendered of the target company. The offer was conditioned on the fulfillment or nonoccurrence of twenty conditions. The target company opposed the offer and issued press releases to that effect. One week after the proposed tender offer was announced, the offer was withdrawn. None of the events that conditioned the tender offer had occurred. In the lawsuit, among other theories of recovery, plaintiffs alleged violations of § 14(e) against the target company and its directors. Specifically, the plaintiffs in *Panter* alleged that the defendants had violated § 14(e) by depriving plaintiffs of the opportunity to tender their shares to the tender offeror and by deceiving plaintiffs as to the attractiveness of selling their shares of stock in the target company in the open market. After examining the purposes of §14(e) as set forth in the legislative history and case law, the *Panter* court held that the plaintiffs had no cause of action under either theory proposed. With respect to the lost-opportunity-to-tender claim, the court stated that because "the tender offer was withdrawn before the plaintiffs had the opportunity to decide whether or not to tender their shares, it was impossible for the plaintiffs to rely on any alleged deception in making the decision to tender or not".

Panter, 646 F.2d at 283. Because this vital element of reliance was missing, the court concluded that plaintiffs failed to state a claim under § 14(e). Regarding the plaintiffs' other claim under § 14(e), the *Panter* court concluded that § 14(e) was not intended to remedy the conduct the plaintiffs' complained of and it held that "§ 14(e) of the Williams Act does not give a damages remedy for alleged misrepresentation or omissions of material fact when the proposed tender offer never becomes effective". *Panter*, 646 F.2d at 286.

In this case, the *Panter* decision impacts on both of plaintiffs' theories under § 14(e). Plaintiffs contend that even though the General tender offer was never made, a large amount of publicity was generated by the announcement of the intended offer and therefore sufficient pressure was imposed on the Microdot shareholders to invoke the protections of the Williams Act. However, because the General tender offer was never made, the plaintiffs' claim with respect to that tender offer comes squarely within *Panter* and fails to state a claim under § 14(e).[1] Plaintiffs also argue that they have a valid claim under § 14(e) because material omissions and misrepresentations were made in connection with the Northwest offer. That tender offer, however, was not announced until January 26, 1976 and was not made until January 28, 1976. Thus, although the existence of a tender offer actually made distinguishes this case from *Panter*, the *Panter* court's conclusions with respect to the legislative intent concerning § 14(e) indicates that plaintiffs do not have a claim under that section.

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[1] Plaintiffs argue that this case is distinguishable from *Panter* because they did actually sell shares of Microdot stock so that the reliance element of § 14(e) is met. This distinction is not persuasive. Even though plaintiffs sold shares of stock they still never had an opportunity to decide whether to tender shares to a tender offeror. It is that decision which is critical to a § 14(e) claim.

The court noted that § 14(e) was designed "to protect an investor faced with the pressures generated by the exigencies of the tender offer context. . . ." *Panter*, 646 F.2d at 285. The court also observed that the "protections of the Williams Act are required by the peculiar nature of a tender offer. . . ." *Id.* at 286. The *Panter* court then concluded that the plaintiff shareholders "were simply not subjected to the proscribed pressures the Williams Act was designed to alleviate". *Id.* In light of the "trend to avoid unduly expansive interpretations of the securities laws", *Id.*, this court concludes that the plaintiffs in this case were also not subjected to the pressures § 14(e) was designed to alleviate because during the time period plaintiffs sold their stock no tender offer was pending. Therefore, plaintiffs' claims based on § 14(e) are dismissed.

Turning to plaintiffs' claims based on § 10(b) and Rule 10b-5, a pivotal presumption underlies defendants' motion to dismiss. They contend that plaintiffs' claims can only be considered as asserting material nondisclosures rather nondisclosures and misrepresentations because the alleged misrepresentations do not materially misrepresent any facts. Defendants then also claim that the specific nondisclosures complained of are not actionable under § 10(b) or Rule 10b-5 as interpreted in *Santa Fe Indus. Inc. v. Green*, 430 U.S. 462 (1977), because the claims only allege at most breaches of fiduciary duty. However, the court cannot accept as a matter of law at this stage of the litigation that plaintiffs have failed to allege material misrepresentations. The issue of materiality is "a mixed question of law and fact . . . [and the] determination requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him. . . . [T]hese assessments are peculiarly ones for the trier of fact". *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976). Furthermore, although "the securities laws do not require defendants to reveal their culpability or motives, [they do not] allow [de-

fendants] to make untrue statements of material facts or fail to state material facts necessary to cure misleading statements". *Atchley v. Qonaar Corp.*, No. 82-1696, slip op. at 7-8 (7th Cir. April 1, 1983). Under these standards, the complaint pleads sufficient facts to survive a motion to dismiss.[2]

Accordingly, defendants' motion to dismiss is granted with respect to the § 14(e) claims and denied in all other respects.

/s/ JOEL M. FLAUM
UNITED STATES DISTRICT JUDGE

DATED: May 23, 1983

[2] Although some of plaintiffs' alleged nondisclosures may not be actionable in isolation, the crux of plaintiff's complaint is that in the context of material misrepresentations, defendants had a duty to disclose.

Name of
Assigned Judge PLUNKETT

Case Number 76C 427 Date: March 18, 1986

Case Title: FLAMM V. EBERSTADT

* * *

DOCKET ENTRY: (The balance of this form is reserved for notations by court staff.)

(1) ☐ Judgment is entered as follows:
(2) ☒ [Other docket entry:]

Defendants motion for summary judgment is denied. Plaintiff's motion to reinstate the section 14(e) claim is denied. Plaintiff's motion in limine is denied. Plaintiff's motion to amend the complaint is denied.

* * *

(9) ☒ Trial set for 31 Mar 86 at 10:15 a.m.

* * *

☒ Docketing to mail notices. MAR 19, 1986

Document # 173

FILED - ED3
1986 MAR 18
CLERK
US DISTRICT COURT

Courtroom deputy's initials: /s/ DW